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# KEEPING MARKETS FAIR: CONSIDERING INSIDER TRADING LEGISLATION

## HEARING

BEFORE THE

## COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED SEVENTEENTH CONGRESS

SECOND SESSION

ON

EXAMINING INSIDER TRADING LEGISLATION AND HOW WE CAN BEST SUPPORT THE AMERICAN PEOPLE BY KEEPING OUR MARKETS FAIR

APRIL 5, 2022

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# KEEPING MARKETS FAIR: CONSIDERING INSIDER TRADING LEGISLATION

**TUESDAY, APRIL 5, 2022**

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
*Washington, DC.*

The Committee met at 10 a.m., via Webex and in room 538, Dirksen Senate Office Building, Hon. Sherrod Brown, Chairman of the Committee, presiding.

## OPENING STATEMENT OF CHAIRMAN SHERROD BROWN

Chairman BROWN. The Senate Committee on Banking, Housing, and Urban Affairs will come to order. Today's hearing is in the hybrid format. Our witnesses are in person. Members have the option to appear either in person or virtually.

The tragedy and uncertainty of the coronavirus pandemic taught us a lot about the economy and the stock market. At first, for a brief period at the beginning of the pandemic, the stock market tracked what was happening in the rest of the economy. As small businesses and families struggled, U.S. stock market suffered the fastest drop in history, plummeting 34 percent in 33 days.

But then, the stock market had the fastest rebound in history, recovering all of those losses by mid-August. Meanwhile, small businesses were making impossible decisions about layoffs or shutting their doors altogether. Fourteen million Americans were unemployed. And last year, we saw record highs in the stock market and all-time records in initial public offerings, private equity, and venture capital. A story just came out that U.S. corporations had their most profitable year since 1950, yet continue to raise their prices.

All of this was a reminder of what most Americans already know—the stock market is detached from the reality of most people's lives.

And it disproportionately benefits the wealthy. No news there, even in the Senate Banking Committee.

According to Federal Reserve data, the wealthiest 1 percent hold 53 percent of stock and mutual fund investments, and the bottom 90 percent own less than 12 percent.

Think about that, just 1 percent of the country holds more than half of all Wall Street assets.

So it is no surprise that most Americans do not trust the markets any more than they trust the banks. They do not think the stock market is fair, and they think the wealthy and well-connected cheat the system, and the facts are on their side. Too often they

are right. It is why today we are examining how Congress must work to crack down on bad actors who cheat the system and cheat Americans planning for the future.

Everyone on Wall Street should play by the same rules. We know that is almost never been the case. Right now, it seems too easy for corporate insiders out on the golf course, in Florida or any other State, to exchange information about upcoming mergers and deals, and then mostly get away with it.

All too often we see insiders, from boardrooms to bankers, involved in suspicious trading. These are people who should know better, people who know when they are crossing the line, but they just cannot seem to help themselves.

The SEC and the Department of Justice have prosecuted insider trading for decades using principles of fraud under the securities laws. Most of these principles have developed without a standard defined by Congress. Most people would probably be surprised to learn that there is no one law written down anywhere that spells out what constitutes illegal insider trading.

Over the years, Federal courts have disagreed on what types of misconduct are in fact illegal, and when the Supreme Court has stepped in, instead of resulting in a clearer understanding of the law, it is just created more confusion on what counts as illegal insider trading.

We should all want strict, clear rules on what constitutes illegal insider trading. We should all want a statute that spells out when someone is crossing the line. That would help avoid this uncertainty and inconsistency.

Since 2014, there has been a debate between the Federal circuit courts and the Supreme Court about when people who provide or receive inside information and trade on it are liable for insider trading.

After the back and forth in those cases, experts still disagree on how much the law changed, where the lines are, and what happens if courts disagree in the future.

We have also seen that there may be limits to our ability to use insider trading case law to hold new varieties of improper trades accountable. This is especially true with the rise of cyber threats, for example, if someone deliberately hacks into a computer system to access inside information and then trades on it. Existing statutes and case law, believe it or not, do not always treat that as wrongful insider trading, even though to pretty much everyone that sounds like a textbook example.

Our colleagues in the House have been considering these gaps. I particularly thank Representative Himes who has been leading on this issue for years. He has pushed legislation that would take away the uncertainty created by the courts and establish standards that address the questions that come up repeatedly. Our colleague on this Committee, a senior Member of this Committee, Senator Reed, introduced S. 3990, a Senate version of that House-passed bill that our witnesses will, in fact, discuss today.

Insider trading cases might not be as cut and dry or as exciting as we see in the movies, but the same kind of misconduct and suspicious trading happens again and again. It is wrong, it is unfair,

and it is yet one more way that the wealthy and the well-connected game the system to get ahead.

It is funny how the people who seem to have the best luck playing the stock market so often happened to have friends in high places. How shocking.

We hear all the time about insiders who have amazing timing and buy stock days before a big announcement, or we read about the chain of people who share a stock "tip," that is clearly confidential information that should not be shared or traded on.

Congress has, finally, the opportunity to make it clear what the rules are.

A statutory definition of insider trading would capture abuses and misconduct—like hacking to steal confidential stock information—that courts have found to be outside the concepts of "fraud" and "deception." Even if the hacker accessed the information because of a security weakness, that does not mean what that hacker did is OK and it should not mean they can keep his ill-gotten profits.

The measure we are discussing today closes that gap by focusing on "wrongfully" acquired nonpublic information. Well-connected people buy sophisticated derivatives on a company's stock on a Friday. The following Tuesday the company announces a merger. To most people that does not sound like just a lucky bet or a coincidence. That sounds more like a wink and a nod, and a "you scratch my back, I will scratch yours" understanding.

And when that happens all the time, it is no surprise that most Americans do not think they can trust the market with their retirement savings. For the vast majority of people who get their income from a paycheck, not a brokerage account, they do not see it as a way to make money.

Families saving for the future deserve to know Congress will protect everyone who invests to send their kids to college or to buy a home one day. We must make sure our laws are written down, they are clear, and they apply to everyone, no matter how powerful, no matter how wealthy.

Senator Toomey.

## OPENING STATEMENT OF SENATOR PATRICK J. TOOMEY

Senator TOOMEY. Thank you, Mr. Chairman.

I will address insider trading, but first I would like to acknowledge that it was 10 years ago to this very day that President Obama signed the Jumpstart Our Business Startups, or JOBS, Act into law. This remarkable piece of bipartisan legislation opened new avenues for companies to raise capital. For example, it created a streamlined path for new startups to go public as "emerging growth companies."

Since 2014, these "emerging growth companies" have accounted for almost 90 percent of all initial public offerings, or IPOs. Despite that, the number of public companies continues to decrease. In fact, the number of public companies has declined 40 percent since its peak in the late 1990s. If not for the JOBS Act, the situation would be even worse today. This decrease in public companies hurts economic growth, cuts off funding avenues for American businesses, and reduces investment opportunities for average Americans.

Although the last 2 years saw more IPOs, this may be an aberration if the large number of SPAC offerings turns out to be a temporary phenomenon. And if last week's SEC proposal on SPACs becomes final, we may see the end of SPACs altogether.

But investors have been clamoring to be part of SPAC offerings, and we ought to ask the question, why is that? My view is that they want growth-stage investments, and it is hard to get them any other way.

Companies face excessive costs in going and staying public, which discourages them from going public in the first place. IPOs used to be a capital raising event. Now, they are too often just a liquidity event for early investors.

These costs of going public will increase substantially if the 23 SEC proposals, announced in only the last 4 months and many that significantly uproot the historical approaches taken in securities regulation, go into effect. For one of the proposals, just the one on climate change, the SEC estimates that it will nearly triple the external costs for companies in preparing their annual 10–K reports. Imagine that.

Think of the money companies spend today on preparing annual reports to cover the entirety of their businesses. And the SEC would nearly triple that cost to add often immaterial disclosure requirements regarding climate change.

In my view, the SEC is taking disclosures in the wrong direction. Unless we change that direction, we could lose America's number one position as the leader in active and efficient capital markets.

That is why yesterday, with my colleagues on the Banking Committee, I rolled out a discussion draft of the JOBS Act 4.0. This draft is the result of a request I made last February for proposals to increase economic growth and job creation by facilitating capital formation.

In response, we received 35 submissions with more than 150 legislative proposals from a wide variety of bipartisan organizations and stakeholders. We turned a number of these proposals into bills, a number of which have received bipartisan support.

These bills encourage companies to be publicly traded, particularly during earlier growth stages, they improve the market for private capital by appropriately tailoring regulations for small businesses, they would enhance retail investor access to investment opportunities, and improve regulatory oversight.

We are seeking feedback on this draft over the next 60 days, and I am hopeful that Republicans and Democrats can come together and find agreement on a new JOBS Act 4.0. This draft acknowledges the important role played by private markets and how they can be improved.

Now some resist improving private markets because they claim that doing so would discourage companies from going public, but if we want to encourage companies to go public, maybe the answer is to make it less onerous to be a public company.

I do not believe that one of type of market, private or public, is inherently better than the other. Indeed, the optimal source of capital for a company might vary at different stages of its growth cycle. Improved private markets can help private companies stay around long enough to grow into public companies.

However, as the pool of public companies shrinks, retail investors are cut out of key investment opportunities. We should expand retail investor access to these nonpublic investments so that they can diversify their portfolios and potentially receive the higher returns available to the wealthy.

We know that union pensions, other institutional investors, and high-net-worth individuals routinely include nonpublic investments, such as private equity and venture capital, as a part of their diversified portfolios. We ought to be ensuring that pension plans like CalPERS and wealthy investors are not the only ones with access to these types of investments.

Now let me turn to insider trading. The securities markets are at the heart of our economy and our financial system. They reflect the collective decisionmaking of many individuals on whether to buy, sell, or hold securities, and in doing so they carry out the critical function of price discovery.

An accurate market price, one that efficiently incorporates all available public information, is perhaps the most important investor protection that exists. Thus, it is crucial that market participants have incentives to use lawful means to discover information, conduct analysis, and develop investment hypothesis and to use those efforts to make better decisions about market prices.

For that reason, insider trading has never been about one market participant having better information over another. Instead, insider trading is about one person wrongfully obtaining, or using, material, nonpublic information in breach of a fiduciary duty or through misappropriation.

In the decades since the first insider trading cases were brought, the courts have developed an extensive body of insider trading law. In my view, it would be preferable for Congress to codify what that law should entail. If we do so, we should be cautious about legislation that could cause confusion, uncertainty, or unintended consequences in this highly technical area, particularly regarding investment research.

I look forward to hearing from today's witnesses about all of these important issues.

Thank you, Mr. Chairman.

Chairman BROWN. Thank you, Ranking Member Toomey. Senator Toomey and I are having a meeting later this week, and I will take a look at these proposals, and I know that the Ranking Member and I would like bipartisan legislation that we can perhaps move forward on making housing more affordable and accessible and strengthening our communities and looking at the JOBS 4.0 Act.

I will introduce today's witnesses.

Professor Robert Jackson, Jr., is the Pierrepont Family Professor of Law and Codirector of the Institute for Corporate Governance and Finance at the NYU Law School. He was nominated and unanimously confirmed by the Senate to be an SEC commissioner, back when the Senate did things in those ways, in December 2017.

Professor Todd Henderson is the Michael Marks Professor of Law at the University of Chicago. He studies corporate and securities law. He is an expert witness in securities fraud, litigation, and on

the subject of insider trading. He served as a judge and on the National Adjudicatory Council at FINRA.

Mr. David Burton is the Heritage Foundation's Senior Fellow in Economic Policy. He focuses on tax matters, securities law, entrepreneurship, financial privacy, and regulatory and administrative law issues. He was General Counsel at the National Small Business Administration before joining Heritage.

Professor John Coffee is the Adolf Berle Professor of Law at Columbia Law School and Director of their Center on Corporate Governance. He served as a member of the Bharara Task Force on Insider Training.

Professor Jackson, please begin your testimony.

And understand, all of you, there will be two votes during this Committee, so people, including the Ranking Member and I, will be a little more up and down than we would like to be at this hearing.

So proceed, please.

**STATEMENT OF ROBERT J. JACKSON, JR., PIERREPONT FAMILY PROFESSOR OF LAW, NEW YORK UNIVERSITY SCHOOL OF LAW**

Mr. JACKSON. Well thank you, Chairman Brown, and thank you, Ranking Member Toomey, for the opportunity to testify before you today.

You know, the last time I had the honor of testifying before this Committee it was at the hearing on my nomination to be a commissioner of the Securities and Exchange Commission. My mom and dad, who grew up in big, Irish Catholic families in the Bronx—my mother is one of nine kids and my father is one of five—proudly sat behind me that day. The day I was born, none of my family had been to college, but my parents plowed their paychecks into the market, and 40 years later they sat behind their son as a Presidential nominee.

So me, markets are important not only because they encourage entrepreneurship and growth, they are important because they make possible for two middle-class parents to change their son's life, and we owe it to families pursuing their vision of the American dream, just like mine did, to make sure that when they invest in our markets they do so on a level playing field.

And that is why, after I was confirmed to be a commissioner I joined Preet Bharara, the former United States Attorney for the Southern District of New York, in calling for a national task force on the law of insider trading. You know, because Congress has never codified insider trading rules, both defendants and ordinary investors like my mom and dad are exposed to gaps in our law.

The task force, featuring a bipartisan group of prosecutors, defense counsel, legal academics, and judges, concluded that Congress should clarify the law of insider trading, and I agree. That is why the Insider Trading Prohibition Act you are considering today is so important. As the task force urged, the act would focus liability on whether information was wrongfully taken, used, or communicated, and for a detailed and thoughtful analysis of those provision I commend to you the testimony of my colleague, Professor Coffee, and his writing on the subject.

My testimony will identify two additional gaps in current law that make clear the urgent need for this legislation. First, current law allows cyber hackers to profit from trading on their activities, and second, insiders at foreign firms listed in the United States, and particularly Russian and Chinese firms, profit extensively from their trading, putting American investors at risk.

As this Committee knows too well, our companies are in a constant battle to protect themselves from hackers who seek access to millions of Americans' most private information, and there is concerning evidence that these hackers not only attack our companies but also trade before the attack is public, raising the prospect that our very markets help finance the cyberattacks that put Americans' privacy at risk.

And as it stands today, the law of insider trading often does not cover that activity. The reason is that establishing insider trading liability under current law generally requires the Government to show that the information was obtained by breach of a duty or by way of deception. But you see, many hackers attack our companies not through deception but by brute for tactics that simply overwhelm our defenses.

Now from the perspective of the judges who made our insider trading law, that distinction might make a difference. But for ordinary investors like my mom and dad, the idea that the law of insider trading allows hackers to profit from the destruction they cause raises doubts about the fundamental fairness of our markets, and this act would close that gap.

Among the most significant impacts of the law would be to clearly outlaw trading on information obtained through cybersecurity attacks, and closing gaps like these is all the more urgent in today's fast-moving markets, where traders are constantly looking for advantages against ordinary investors.

And in a study released last week, my coauthors and I examine another such gap, insider trading by executives at foreign firms listed in the United States. As this Committee knows, foreign companies domiciled in China and Russia now raise significant funds from American investors by listing on U.S. stock exchanges. Unlike executives at American companies, however, insiders at foreign firms are not subject to prompt disclosure of their trades in their company's stock, raising the risk that our outdated insider trading law allows foreign firm insiders to take advantage of ordinary investors.

So Daniel Taylor and Bradford Lynch of the Wharton School, and I dug into the data. Drawing on the unique dataset based on thousands of paper filings with the SEC, describing sales of stock over a 5-year period, we study whether foreign firm insiders are able to avoid losses on U.S.-traded stocks by selling in advance of price declines—and the results are striking.

Our data provides systematic evidence that foreign firm insiders avoid substantial losses by selling shares before the stock price drops, and this activity is concentrated in firms domiciled in just a few countries overseas. When insiders of U.S.-listed Chinese companies sell shares, their median company stock price falls by 23 percent in the 12 months after that sale. And when insiders at U.S.-listed Russian firms sell, the median firm stock declines by 21

percent. These sales allow foreign firm insiders to avoid significant losses in dollar terms. Indeed, we estimate that insiders at Chinese-domiciled, U.S.-listed companies have avoided over $10 billion in losses as a result of well-timed stock sales.

It is far from clear why foreign firm insiders should be playing by a different set of rules than their American company counterparts, who must disclose their trades promptly to investors, and that is why the SEC should reconsider foreign firms' exemption from the insider trading disclosure rules companies must follow under the Exchange Act.

For decades, the judge-made law governing insider trading has left gaps inviting insiders to take advantage of ordinary investors, and Congress should make clear that all participants in our markets must play by the same rules.

Thank you for the opportunity to testify before you today, and I would be delighted to answer your questions.

Chairman BROWN. Thank you, Professor Jackson.

Professor Henderson, welcome.

**STATEMENT OF PROFESSOR M. TODD HENDERSON, MICHAEL J. MARKS PROFESSOR OF LAW, UNIVERSITY OF CHICAGO LAW SCHOOL**

Mr. HENDERSON. Thank you, Mr. Chairman and Members of the Committee. For a kid from Appalachia, this is a great honor to me to be in the world's greatest deliberative body, so thank you for having me.

It is an important topic we are talking about, capital raising and insider trading. These issues, as the Ranking Member said, are at the heart of our economy. Every company has to raise money, and laws and regulations have a tremendous impact on how this is done, and more importantly, how much it costs.

It is easy, and maybe politically appealing to add more and more obligations on companies, but the costs of compliance do not just fall on rich investors and abstract companies. They are paid for by every American. While we need laws to prevent fraud and ensure accurate disclosure of information, every dollar spent on complying with regulations is a dollar not spent on employing workers, investing in research and development, and in bringing products and services to everyday Americans. The goal of law should be to obligate companies to spend no more than absolutely necessary to protect investors and ensure robust capital markets. After all, we all pay for regulation, and we should only be willing to do so if the benefits exceed the costs.

There is no real question that the costs of fundraising are too high today. The burdens of securities disclosures are many times higher than they were just a few decades ago. To give just one example, disclosure obligations under Regulation S–K. It has 102 specific items of disclosure set forth in over 140,000 words on 385 pages of the Code of Federal Regulations. These rules have grown 20 times in length since 1980. This means lots of lawyers can find work, which is fine for me as a law professor, but fewer engineers, chemists, and others who actually discover things that improve the lives of people.

The risks of meritless securities fraud suits also remains high, despite Congress' effort to eliminate them. The result has been a sharp drop in the number of public companies. There are about half as many today as there were in 2000. And companies are also resorting to new ways to raise capital, like SPACs, as a work-around going public. And while the verdict is still out on SPACs, the fact that such innovation is viewed as necessary by investors and companies should give regulators pause before piling on new costs of going public through traditional means.

Instead of trying to reduce the burdens on public companies, the SEC is doubling down, issuing proposed rules that will straddle investors, workers, and customers with more costs. At the same time, it is hampering the ability of all Americans to invest in private markets. Private companies are an important alternative to public ones, and returns in the private equity market and other alternative asset classes have been superior to public returns in recent decades. This is not only an important investment opportunity for investors of all kinds but it helps turn around struggling companies, offers all companies an alternative governance approach that can fit their needs at various times, and, most importantly, provides discipline against public company managers that may act in a self-serving way. Congress and the SEC should expand the opportunity of every investor to access private equity and other asset classes, consistent with fiduciary duty obligations under ERISA and other laws.

Let me turn briefly to insider trading. When we are talking about insider trading it is important to put aside the conventional wisdom that it is unlawful to trade based on "material nonpublic information." Investment advisors and stock market analysts make their living seeking informational advantages for their clients. Without these incentives, there will be less information about stock prices, which means stock prices will be less accurate. The consequence will be that capital will not be allocated to where it is most valuable. This harms everyone, not just investors.

Insider trading based on an informational advantage is only illegal when it results in a violation of the antifraud provisions of the Federal securities laws. Under existing case law, that generally happens when a corporate insider trades on material nonpublic information for his benefit, when someone deceptively takes nonpublic information that does not belong to them and uses it to trade, or when individuals provide—like a "tipper"—the material nonpublic information to someone else in return for a personal benefit. Justice Ginsburg made this property-based approach clear in her opinion in United States v. O'Hagan.

The Insider Trading Protection Act purports to merely codify this existing law but it goes way further than this. When law professors can turn everyday scenarios, like overheard conversations about deals and documents left in the back of airplane seat pockets, into challenging law school hypotheticals, the result is a huge chilling effect on the work necessary to ensure accurate stock prices.

This means not only the opportunities for misallocation of capital but also large compliance costs for investment funds. Importantly, these costs of ensuring investment professionals do not violate the law will fall disproportionately on smaller and mid-sized invest-

ment funds. To make matters worse, these funds are likely to be owned and operated by women and minorities, and likely to be the ones taking alternative positions on things like ESG and other related matters.

There are a few problems with the ITPA in its current form.

It purports to codify the existing personal benefit requirement for a tipper, but includes the language “indirect personal benefit.” It is possible to describe virtually any human interaction as providing an “indirect benefit” to the participants. Instead, the law should reflect the commonsense notion that the source of information either received something tangible and valuable in return or provided something like a monetary gift to a relative or friend.

Second, the act uncontroversially states that trading on information wrongfully obtained by theft, deception, and so on will lead to liability. But it contains a very broad provision about confidentiality. This is a system ripe for abuse, with companies potentially able to prevent investors from trading merely by providing them with information they do not want.

Third, it expands the types of traders who can be held liable for insider trading. Currently, a trader has to act with some intent to violate the law. Under the bill, however, anyone who, quote, “was aware, consciously avoided being aware, or recklessly disregarded” that the information was wrongfully obtained or communicated can have a case brought against them. The ITPA is silent on what “recklessly disregarded” means, which would appear to rope in innocent traders along with actual wrongdoers.

Finally, the ITPA does not contain an exclusivity provision. There is a provision of Federal criminal law, 18 U.S.C. 1348, which the Department of Justice has used to criminally prosecute cases of insider trading where there was no personal benefit. Without an exclusivity provision, the Government will just use that provision, avoiding the entire ITPA to bring cases. So the ITPA should include an exclusivity provision.

There is little dispute that the knowing use of material nonpublic information is wrong. It is known as “stealing,” and that is what the Government should be trying to prevent. At the same time, we do not want to chill the valuable communications that go on between company insiders and market participants, which provide investors with important real-time information about their investments. This is an opportunity for Congress to establish insider trading provisions with a clear set of limited rules that we should follow. But the law should be changed to clarify what a “personal benefit” is, drop the catchall provision about wrongfully obtained information, require an actual knowledge requirement, and make it the exclusive basis for bringing insider trading claims.

Thank you for your time.

Chairman BROWN. Mr. Burton.

**STATEMENT OF DAVID R. BURTON, SENIOR FELLOW IN ECONOMIC POLICY, ROE INSTITUTE FOR ECONOMIC POLICY STUDIES, THE HERITAGE FOUNDATION**

Mr. BURTON. My name is David Burton. I am Senior Fellow in Economic Policy at The Heritage Foundation. I would like to express my thanks to you, Mr. Chairman, Ranking Member Toomey,

and other Members of the Committee for the opportunity to be here this morning.

Because today is the 10th anniversary of the 2012 JOBS Act, a bipartisan achievement of consequence, I have been asked to focus on entrepreneurial capital formation issues in my testimony. Specifically, my written statement addresses the importance of the original JOBS Act, the importance of entrepreneurial capital formation to the economy and the American people, the importance of regulatory impediments to entrepreneurial capital formation, and legislative proposals that have been introduced to this Congress and have been incorporated into the JOBS Act 4.0 discussion draft.

In addition, I discuss a number of statutory improvements that this Committee may want to consider and some fundamental reforms in securities laws that could help entrepreneurs, larger public companies, and the return to investors.

The 2012 JOBS Act has had immeasurable positive impact and improved entrepreneurs' access to capital. JOBS Act offerings account for 3 to 7 percent, depending on the year, of private capital raised. In addition, the emerging growth company provision included in Title I of the JOBS Act arrested the precipitous decline in IPOs, initial public offerings, and since then they have been largely flat.

The JOBS Act made five basic changes to the law. They fall into five basic categories: smaller public "emerging growth companies" or EGCs; general solicitation under Regulation D; crowdfunding; an improved small issues exemption, often called Regulation A+; and changes to the registration threshold allowing more companies to remain private.

Title I relating to emerging growth companies was a major contributing factor in stopping the decline in IPOs. Title II, permitting general solicitation in Regulation D offerings, resulted in Rule 506(c), and this has helped companies raise $65 billion to $200 billion annually. It is a major and underappreciated success.

Title III, crowdfunding, has largely been a failure because of the underlying statute and major regulatory piling-on by the SEC. Both the tiny crowdfunding issuers and funding portals are significantly overregulated. The SEC revisions that took effect last March may help reduce this problem, but they are not going to solve the underlying problem.

Title IV, Regulation A Plus, is a modest success. It currently is used to raise about $1 billion annually. Some relatively straightforward changes, the most important of which is addressed in the discussion draft, could make Regulation A a much more important source of entrepreneurial capital formation.

The legislative proposals incorporated in the JOBS Act 4.0 discussion draft would, as a package, dramatically improve entrepreneurs' access to capital and improve investor protections and returns. The legislation would remove restrictions on secondary market sales but seriously impede the ability of investors to recognize full value for their investment. It would democratize access to private equity markets, enabling more investors to diversify their portfolios and achieve higher returns, and it would make major improvements to the rules governing emerging growth companies, Regulation D, Regulation A, crowdfunding, micro-offerings, finders,

exchanges, periodic disclosure requirements by issuers, business brokers, small broker-dealers, investment companies, retirement plans, and many other areas.

It is an extremely constructive piece of legislation that would generally improve people's lives, and I do not have the time right now to address all the positive aspects of this legislation.

I would specifically like to talk about the SEED Act, which creates a micro-offering exemption and would have a very positive effect on the smallest companies in the United States.

The Unlocking Capital for Small Business Act is a well-drafted piece of legislation that addresses a major problem created by the SEC and is underappreciated in Washington. It would help the smallest entrepreneurs access capital found in money centers, using finders and private placement brokers, potentially helping tens of thousands of small businesses each year, or more.

Similarly, the Small Business Mergers, Acquisition, Sales, and Brokerage Simplification Act would clarify the rules governing broker-dealers.

The Equal Opportunity for all Investors Act is an extremely constructive piece of legislation that would democratize access to private offerings. Section 308 of the bill relating to retirement savings modernization would make it clear that fiduciaries managing defined contribution plans can invest in private equity and other assets. And there is a host of other very constructive legislation in this discussion draft.

In my written remarks I made a number of suggestions for additional reforms. I look forward to working with the Committee on these matters. The discussion draft is very important legislation, and the process that you have begun will result in a strong, well-thought-out bill that will help millions of Americans. Thank you.

Chairman BROWN. Thank you, Mr. Burton.

Professor Coffee, welcome.

**STATEMENT OF JOHN C. COFFEE, JR., ADOLF A. BERLE PROFESSOR OF LAW, DIRECTOR OF THE CENTER ON CORPORATE GOVERNANCE, COLUMBIA LAW SCHOOL**

Mr. COFFEE. Chairman Brown, Ranking Member Toomey, and fellow Members of the Committee, thank you for inviting me. I expect you are going to be happy to hear that I am going to radically condense my written testimony to focus on just two questions. One, what is right with this bill—and there is much that is right with this bill—and what is wrong with this bill—and there is one thing that is tragically wrong with this bill because it will be a backward step that will permit all professional traders—hedge funds and other active investors—to trade on large amounts, counseled by their counsel, so that they will never be involved with a personal benefit. Once you impose the personal benefit requirement it can be outflanked by sophisticated parties, and it will be impossible to prosecute them, and accountability will be lost.

Let us go first to what is right with this bill. It is overdue to have legislative codification of this bill. Insider trading was defined by the SEC in 1961, in the Cady, Roberts decision. That is over 60 years ago. Since then there has been a constant dialogue between the SEC and the courts. Sometimes the courts have cut the SEC

back. Sometimes they have tolerated various expansions and outflankings.

But Congress has been totally left out of that conversation and dialogue. Yes, Congress knows it is against insider trading because it keeps raising the penalties periodically, and that shows their position. But the consequence of this kind of a common-law crime through judicial interpretation is that courts treat insider trading much like they would create a common-law torte. They constantly expand it at the margins more and more, and it grows over time. OK. Once that happens you have greater disparity among the circuits. There is high disparity now. Some circuits require personal benefit. Some, like the Second Circuit, where most of the action is, does not today.

And you cannot really end that problem by passing the statute, because as Professor Henderson properly pointed out, there is another statute, 1348, which allows you to prosecute securities fraud and insider trading, and makes very clear that when it was passed as part of the Sarbanes-Oxley Act that it did not intend to impose many requirements. It greatly simplified these prosecutions, and thus the courts have upheld that. Several decisions have said that, but the most important is Blaszczak, which right now has been remanded on a different issue, back to the Second Circuit.

You could write a statute that says 16A is exclusive. I think that would be much too quick and much too rash, because there are all kinds of implications, and we do not know what is going to happen yet when the Second Circuit deals with the Blaszczak decision on remand from the Supreme Court, and what the Supreme Court would do after that. So it would be legislating a little hastily to make this statute exclusive. But if it is not exclusive, prosecutors are not dumb. There is a hard route and an easy route, and they will take the easy route, and that is 1848.

Now let me go from what was right with the statute—and I have not touched half the things that are right with it. By the way, I am biased on this because I did work with Congressman Himes on the original drafting of this statute, so I know the good things that are in there, and there are many.

But what is wrong with it, and this is the personal benefit requirement. And what is wrong with the personal benefit requirement? Well, since the bill was adopted, was introduced and passed in the House, the Preet Bharara Commission, or Task Force, came out with this report on insider trading. It was staffed with judges, prominent prosecutors, prominent SEC enforcement attorneys, and a sprinkling of modest law professors, including myself, so I am biased there too.

But is said the principle obstacle to insider trading prosecutions today was the personal benefit requirement, and it applied particularly to the sophisticated traders that we most want to hold accountable. It made a recommendation. It said we have got to get away from personal benefit and focus more broadly on wrongfulness. Wrongfulness would be the better alternative standard. Was this behavior clearly wrongful so the person that we are prosecuting would have been conscious of the wrongfulness of this behavior? That does not require you pay a bribe.

When you look at the best-known insider trading cases, and the one that caused much of the consternation, which was the Newman decision, one hedge fund got inside information improperly and tipped another within seconds it was received. Actually, they tipped three or four, but the other was prosecuted, made $72 million on that transaction in 1 day of trading. That is not small time. That is a big-time crime, and under this bill it would be perfectly permitted to do this. There would be a royal road how you could successfully engage in insider trading.

Why does this tipping occur among hedge funds? Very simply because Wall Street is effectively a giant favor bank. There are norms of reciprocity among these activist hedge funds. If I tip you, you have got to tip me, or I will not do it again. And in that world where everybody knows that you have got to keep your deposits and your withdrawals in balance, we will have people tipping back and forth without a personal benefit.

On that note I will just say again, I think you would make a tragic mistake if you left in the personal benefit requirement. Thank you.

Chairman BROWN. Thank you, Professor Coffee.

I will start with you. On the legislation we are discussing, Senator Reed's bill that updates Representative Himes' bill that you worked on, lays out a framework that bans insider trading and identifies when sharing insider information is wrongful and when trading inside information is wrongful.

Why is it important, Professor Coffee, for Congress to target wrongful conduct?

Mr. COFFEE. Well it is the alternative to focusing on personal benefit, which is overly narrow. Personal benefit says if you do not pay a bribe you can do this, but you can do it without paying a bribe because there are norms of reciprocity in the world of people who interact regularly. And you do have personal benefit down there in Standard 11D of the statute. All you have got to do is take out three or four words—for a direct or indirect personal benefit. Now if those words were taken out I would be happy to support this bill, which I worked long and hard on before it was initially introduced. But there was a last-minute, within minutes of this bill being passed in the House, that change was made, to put personal benefit back in, and I think it was ill-advised.

Chairman BROWN. Thank you. A couple of questions for you, Professor Jackson. Some argue the courts have addressed insider trading for so long that Congress does not need to legislate, but we have seen courts disagree on liability for insiders, or tippers, who pass on confidential information, and the recipients, known as tippees, who trade on it. How have these disagreements affected the enforcement of insider trading cases?

Mr. JACKSON. Well thank you, Senator. I think this lack of clarity has caused real problems in the application and enforcement of securities law. You know, when I was an SEC commissioner we often worried about whether the law was clear enough for us to be able to proceed against defendants, even when we were convinced that they had used information wrongfully. And the costs of that, sir, are real. There are cases that cannot be brought, and when market participants know that we are not able to hold them ac-

countable when they do something wrong like that they tend to do more of it.

So I think this lack of clarity has been a real issue. And I just want to be clear about something, Senator. The fact that the courts have spoken on the issue does not mean Congress should not. Quite the opposite, sir. In my view it is Congress that should speak clearly about what the law is in this area, and drawing on the experience of the courts to be sure.

Chairman BROWN. Professor Jackson, illuminate this for all of us. Tell us, if you would, about common facts across insider trading cases that would indicate someone knows they are engaging in wrongful trading. Walk that through for us.

Mr. JACKSON. Sure. Well, a fact pattern we saw with surprising frequency, that I saw when I was a corporate lawyer and that I saw as an SEC commissioner, is when somebody in possession of material, nonpublic information will buy short-dated, out-of-the-money call options, for example, taking advantage not just of the information that they have but the ability to make as much profit from it as quickly as they possibly can.

Often when we see that pattern defendants respond that they were very lucky. And, sir, at least I have not been the benefit of that kind of luck in my experience in the stock market. Nevertheless, this kind of activity is well-known to the SEC and the courts, and candidly, we know wrongful trading when we see it, sir.

Chairman BROWN. Professor Coffee, critics of the insider trading legislation suggest that it will criminalize everyday activities like stock research, accidental communications of confidential information, and expand the scope of illegal insider trading beyond its current limits. Is that a realistic reading of the legislation?

Mr. COFFEE. Not if you assert a clear wrongfulness requirement. I fully agree with what Professor Henderson said. Merely the possession of material, nonpublic information does not create a duty not to trade. It is only when you breach a duty, whether it is a duty to the shareholders, a duty to the source of the information, or a duty to the last tippee who told you.

If you know that this was wrongfully received information you are really in the same position as the classic fence in a theft case. Fences who receive stolen property, knowing that this property was wrongfully obtained and acquired, are going to be criminally liable for selling the property, moving it on. You cannot receive stolen property. I do not think you can receive stolen information. Inside information that has been received by a breach of a fiduciary duty is really a kind of stolen information, and if there is consciousness of that your behavior is wrongful.

If you talk to lawyers in advance, you will make sure you do not ask for a personal benefit, and you do not receive a personal benefit, and then, under the personal benefit standard, you are immune. But you should not be immune. If it is wrongful behavior because you had consciousness that this was stolen information, I think that is sufficient to justify prosecution.

Chairman BROWN. Professor Jackson, do you want to add anything to that?

Mr. JACKSON. Absolutely. I think one of the issues in our insider trading law, Senator, is that it just has not kept up with the way

that markets work. You know, the idea that in order to prove a case against an insider tipper, or is giving information to an insider trader, that the Government has to produce a bag of cash that she received in exchange for her secrets, strikes me as both an unrealistic burden for the Government to carry and also not the way information moves in our markets.

As Professor Coffee explained, I think quite correctly, sir, the way information is shared in our markets these days is through an extensive system of conversations and favors among market participants, and the law can and should capture that when it is wrongful.

Chairman BROWN. Thank you. Senator Toomey.

Senator TOOMEY. Thank you, Mr. Chairman.

Professor Henderson, I get the sense that there is a little bit a disagreement on the panel, that Professors Jackson and Coffee have a different idea of what the standard should be for liability. And I think that the distinction pivots on this personal benefit versus indirect benefit standard.

So I wonder if you have a response to the arguments that they have made as to why you, if I remember correctly, do not believe the indirect benefit standard should be the appropriate standard, but also what would be the adverse effect if that were to become law?

Mr. HENDERSON. Thank you, Senator. I have a lot of agreement with what they have said about cyber hacking and great respect, and I agree. I think the focus, as Professor Coffee said, should be on stealing.

Professor Jackson said the SEC knows wrongfulness when it sees it. I am skeptical of that. The most famous insider trading case probably ever was SEC v. Dirks, where the SEC's view was that Mr. Dirks, who was trading on information revealed to him by an insider at a company that was running a giant Ponzi scheme, was wrongful, and they wanted to punish Mr. Dirks.

Taking information from a company that is running a Ponzi scheme, that they had tried to tell the Government, on repeated occasions, was a Ponzi scheme and nobody would listen, and trading on that information to move the stock price in the right direction, that is not wrongful conduct. It might be stealing from the standpoint of the company, whose property has the information, but it is not wrongful in any sense.

The SEC, frankly, their attitude for the last five decades has been to try to create a parity of information between traders, that people should trade based on the same information, and if that is the view of the Commission and their idea of wrongfulness, I think that is a real problem.

I think the idea that what Professor Coffee said, which is if someone steals information in return for some financial gain—and it does not have to be a bag of money, as Professor Jackson said; it could be a favor you are doing for someone—knowing you are going to get something in return, something that you are doing this to serve your own selfish interests, that is a problem. That is just like stealing office furniture. We do not allow people to do that.

If what you are doing is really not about serving your own personal interests, it is about revealing fraud within a company, then

I think that is a completely different situation. This idea that we are going to have a property rights approach where the companies get to determine what the property is I think is the wrong way to go. I think we should focus on the stealing, and I think we should say when people have motives to steal that are person, self-serving, you do not need a bag of money. The Government does have to show the burden. But if they can show the networks that Professor Coffee is talking about, of information trading and groups of people in these activities, then I think that should be enough.

Senator TOOMEY. Thank you. Mr. Burton, we have had several observations about the huge decline in the number of public companies in America, despite the fact that we have more people, we have more businesses, we have a bigger economy, yet we have fewer publicly traded companies. Just briefly, what do you think the main reason is we have fewer public companies in America today than we did decades ago.

Mr. BURTON. I think there are two related reasons. One is a massive increase in the regulatory burden of being a public company, that has been ongoing for approximately three decades, and it is about to get radically worse if the SEC promulgates some of the rules that it has recently proposed.

The second reason is a substantial increase in litigation risk and the costs associated with either preemptively protecting yourself against that litigation or defending against litigation.

Senator TOOMEY. With respect to the SEC's new raft of disclosure requirements, it is my understanding that for the first time the SEC is going to require the disclosure about facts that are not financially material to the companies that have this burden. That strikes me as a whole new layer, approach to regulation. I wonder if you have any thoughts on the wisdom of that.

Mr. BURTON. I think going down that path is a serious mistake, but they are, in effect, trying to redefine the way materiality has been understood for eight decades. And the proposed greenhouse gas emission rule, or climate change disclosure rule that was released about 2 weeks ago would literally triple the cost of being a public company, and that is going to have dramatic effects. It will make the going-private transactions associated with Sarbanes-Oxley's internal control reporting requirements look like child's play.

And then also if you look at the OMB Unified Regulatory Agenda there is a whole series of other similar type disclosure requirements in the pipeline relating to DEI or human capital management, and so on down the line, which have either no relationship to financial outcome of a company or a tangential relationship to the outcome of the company.

Senator TOOMEY. And that is a complete departure from the historical norm on the terms of the——

Mr. BURTON. It is, and I think ultimately it may well—well, I know it will seriously undermine securities law, because there is this variance with its fundamental historical purposes of helping to provide material information to investors so our capital markets are more efficient, and so that investors can make more informed investment decisions.

Senator TOOMEY [presiding]. Thank you. Senator Menendez.

Senator MENENDEZ. Thank you. Let thank the Chairman for holding this hearing. I also want to thank my colleague, Senator Reed, who is at the Armed Services Committee, for his tireless work to pursue legislation that we are working on together. He and I have been working to codify and clarify our laws regarding insider trading since 2015, when we introduced the Stop Illegal Insider Trading Act.

I am glad to be able to continue that work today with the discussion of our new bill, the Insider Trading Prohibition Act. I believe this is commonsense legislation that will provide much-needed clarity and regulatory stability as well as protections for investors.

So let me turn to my questions.

I believe that everyone is more or less in agreement that insider trading is unfair, and that, to me, is reason enough to clearly and explicitly ban the practice. However, I also want to push back on the idea that it is a victimless crime. One of the reasons I believe it is important to codify our laws against insider trading is that the practice has tangible negative effects on the economy.

Professor Jackson, can you talk about some of the negative consequences of insider trading on markets and shareholders and the public at large?

Mr. JACKSON. Absolutely, Senator. Thank you. Our inability to enforce the insider trading laws and the limits of the judge-made doctrine that we have has very real costs for ordinary Americans. What it means is that when they enter our markets they cannot be as sure as they should be, sir, that they are going to be on a level playing field, but instead that they might be trading against individuals who have better information than they do, for reasons unrelated to the actual underlying value of the stock, but instead because those individuals are in a privileged position, for example, in the senior management of the company.

Those are very real costs that ordinary families face. And when they try to plan for their retirement or education we should do better in making clear to them that when they put that money in the market, like my parents did years ago, they are going to be on a level playing field rather than trading against somebody who knows more than they do simply because they happen to work at the company.

Senator MENENDEZ. Yeah. I think insider trading can increase market volatility and certainly reduce confidence in markets and companies at the expense of shareholders, which is why I think it is important that we act.

Let me ask you, one of the goals of the Insider Trading Prohibition Act is to clarify certain conflicts that have arisen in the courts. One such clarification is that this legislation makes it unlawful to trade securities based on information that the trader knows or has reason to know was wrongfully obtained, regardless of whether the trader knows whether a source breached a fiduciary duty and/or if they derived any personal benefit.

Can you explain to the Committee what led to the court conflict over personal benefits and why this clarification is important?

Mr. JACKSON. Absolutely, Senator. What happened in the courts is they were trying to understand when a tipper inside a company gives information to a trader, why she did that. And what they did

was use the personal benefit approach as a way to understand whether she was personally getting something by giving away this information.

While in theory that sounds like a good idea, Senator, the problem is, in practice, as I was suggesting earlier, the way financial markets work is that people do not trade information for bags of cash. No. They trade information, as Professor Coffee has explained, in relationships, conversations, trading favors, et cetera. That is the way information passes in our markets today. And if we make the Government prove that they handed over cash in order to give up their secrets, what that really means is that we will not be able to bring those cases. And as you pointed out, Senator, what that means is that ordinary Americans cannot be sure they are getting a fair deal when they invest in our markets.

Senator MENENDEZ. OK. I raised this point—and thank you for your answer and your insights—because it exemplifies what the legislation is all about. It is about making sure that the law is clear, that it resolves existing ambiguities, and covers the full range of practices that constitute insider trading. If someone knowingly trades on insider information it should not matter whether that person that shared the information violated a duty or received a benefit.

Finally, one question Congress has been grappling with is how to fit digital assets into existing financial and regulatory frameworks. Though our bill does not directly deal with digital assets it is important to consider how these assets might interact with insider trading regulations.

Dr. Coffee, what concerns, if any, do you have regarding insider trading of digital assets.

Mr. COFFEE. Well, right now, of course, the securities laws do not apply to cryptocurrency as such. It does apply to certain initial public offerings of cryptocurrencies. That is a funny distinction. But I do think that it is the Wild West out there in terms of cryptocurrencies. We do not know what is going on, but it is extremely volatile and people are making or losing billions, and I do not want the small investor getting into that until the market is cleaned up and the West becomes a somewhat tamer place. That is the world of cryptocurrencies.

I just want to emphasize what the professor, my colleague, was saying a minute ago. The Bharara report is not for making strict liability. It is not for making insider trading very easy to prosecute. It is instead saying using only the personal benefit standard is under-inclusive. Properly counseled by good lawyers, hedge funds can avoid making a payment or promising a payment, and then they are immune, if you use the personal benefit standard.

What you should instead use, and I think this is the representative body, the Bharara Commission, is we should instead use a wrongfulness standard, that the parties know they were behaving wrongfully. When you tell someone else, "We just got word Dell is going to reduce its earnings by 50 percent. It will be announced the day after tomorrow," and the two hedge funds trade like wild and make, in the case of the Newman case, something like $72 million in that 1 day, I think that is the kind of behavior that I can say shows wrongfulness.

And if you want to add a little bit more to the statute to make that wrongfulness requirement even clearer, we are not suggesting strict liability. We are suggesting if you behave wrongfully but do not pay a clear bribe you can still be held liable. If you do not say that you have created a royal road for hedge funds to get very rich and behave very badly.

Senator MENENDEZ [presiding]. Thank you. Senator Tillis.

Senator TILLIS. Thank you, Senator Menendez. Thank you all for being here today.

Mr. Burton, one question I have for you is I think there are a lot of hard-working Americans that find themselves on the outside looking in, especially when it comes to opportunities to invest in a deep and diverse pool of young companies with significant growth potential. So I and a couple of my other colleagues believe it is important to update the rules of the road so more everyday Americans—and not just large funds—can chart their own economic path as early stage and accredited investors.

Senator Scott and I have introduced a bill called the Equal Opportunity for All Investors Act, and the legislation updates laws on accredited investor status to allow examinations and subsequent self-certifications for accredited investor status.

Do you think that increasing access to early growth companies are an important way to democratize investing?

Mr. BURTON. Absolutely. I believe your legislation is extremely constructive legislation. It will give less-affluent investors access to high-growth companies, enabling them to achieve higher returns and also diversify their portfolios, and make it so that the securities laws basically do not set up the system so that only rich or very affluent people can participate in these offerings. And that is, I think, a very important step forward.

The other thing I mention is the fact that you allow people to test into the status by demonstrating investment knowledge gives life to something that has been in Regulation D since its advent, namely the concept of a sophisticated investor. But because people do not really know what it means, it is not used very often and the bright-line thresholds relating to income and net worth are used instead. So that would enable someone who actually is sophisticated to demonstrate that by taking a test administered by someone like FINRA.

Senator TILLIS. Anyone wishing to speak in opposition? Mr. Robert.

Mr. JACKSON. Well thank you, Senator.

Senator TILLIS. I like creating a debate format from time to time, particularly when there are not a lot of Members here.

Mr. JACKSON. Thank you, Senator. Certainly it is important to give people opportunities to raise capital, sir, but I was actually very pleased to see that part of the package that has been rolled out includes an issue in the cost of raising money that has not been addressed by the SEC, and that is the tax that small- and mid-sized companies pay when they go public, to Wall Street.

You know, sir, for 20 years there has been clear evidence in the finance literature that when a small or mid-sized company goes public in this country they give 7 percent of what they created as entrepreneurs over to Wall Street. Not 6.5 percent, not 7.5 percent,

but exactly 7 percent. It is not my experience, sir, that competitive markets set prices at the exact same level for 20 years in a row.

When I was on the SEC I called for us to study this and ask why do small- and mid-sized companies in this country have to pay this tax on the toll road to going public? And I was delighted to see that part of this package is going to ask the SEC to study that question and get after why it is so expensive for small- and mid-sized businesses to raise capital in our markets.

Senator TILLIS. Mr. Burton, 45-second rebuttal.

Mr. BURTON. He is absolutely right on the aspect that we need to study the costs associated with initial public offerings. We need actual better information from the SEC across the board.

I work in a number of different fields, and the Department of Labor, the Internal Revenue Service, the Commerce Department all put out a great deal of information every year so we know what is going on in that area. The only place where that is not true is the Securities and Exchange Commission, and we talked about that a little bit when you were a commissioner. Basically, the SEC is extraordinarily bad at providing information to policymakers like yourselves, and we need to fix that.

In terms of your legislation, more specifically on amending the accredited investors, not only will it democratize access to these private placements, it will also help entrepreneurs, particularly in rural areas or smaller States. Because if you live in Washington, an entrepreneur is likely to know a tremendous number of accredited investors. If you live in a smaller community where incomes and net worths are lower, you do not have access. And I think people typically here, in Washington, do not focus on how rare accredited investors are in much of this country, and your legislation will help address that disparity.

Senator TILLIS. I am about to run out of time, but one question, Mr. Burton—I may just see if I can get your response, a question for the record. I have worked on the Reporting Requirements Reduction Act, which had to do with going from quarterly to semiannual reporting. I think that you expressed maybe some, if not concern but expressed some opinions that I would be very interested in. But I still believe that we need to right-size regulations, and you are talking to a former partner at PricewaterhouseCoopers who built a big firm that had a lot of regulatory compliance. But I think it would be nice to be able to lower the temperatures here, because when we are talking about right-sizing regulations, I am not talking about walking away from something that is a real risk that needs to have oversight, but doing it in a tailored, more modern way.

Your just general comment on regulatory tailoring.

Mr. BURTON. I have totally been a strong proponent of scaled disclosure for a very long time. I totally share your concern that we are having an extraordinary adverse impact on entrepreneurs because we over-regulate and impose costs.

In terms of your specific proposal to reduce the frequency, in effect replace 10Q's with semiannual reporting of financial statements, I have some reservations, although it is possible that it would work out. Obviously it would reduce costs, but it is also going to reduce the amount of information available to the market-

place so that it can accurately price securities in the secondary market.

On the other hand, it is not like there will not be any information, because there is 8-K report, current reporting requirements. So it may very well work out fine.

What I would suggest is that maybe we run, in effect, a test and limit it to smaller reporting companies or maybe smaller reporting companies and EGCs and see if that works before it is generalized.

Senator TILLIS. Tailor it further. Thank you. Thank you for the input.

On behalf of the Senator Brown, Senator Warner, you are recognized.

Chairman BROWN [presiding]. Thank you, Senator Tillis.

Senator WARNER. I was going to call you Mr. Chairman.

Senator TILLIS. You are exactly right. I was just trying to——

Chairman BROWN. Tillis always does whatever I ask. It is unbelievable.

Senator WARNER. I am not even going to complain about the extra minute you took, Senator Tillis.

I am going to start with Professor Jackson, and, you know, talk a little bit about cybersecurity. This is an area where I see it not only from this Committee's standpoint but particularly I see it from my chair on the Intel Committee. Unfortunately, we have seen a dramatic rise in cyberattacks. We have seen a dramatic explosion of ransomware payments.

I am happy that I think virtually everybody on this Committee has supported the bipartisan legislation to make sure we have actually got a cyber incident reporting that is now law. Only about 30 percent of cyberattacks are actually reported. And if we do not have mandatory reporting, frankly, not to go after the company but to identify and share with other private sector partners, bad, bad things will happen, and frankly, I am still amazed that we have not seen more Russian cyber activity against our institutions in light of the Ukraine war.

Professor Jackson, I know in your testimony you touched on this. We often think about cyberattacks in terms of ransomware, but as you pointed out in your testimony there is actually the ability that victims' stocks can actually be manipulated. Can you talk about how prevalent this practice is and how some of these cyberattacks can move beyond traditional ransomware, and whether this is actually extending to potentially State actors?

Mr. JACKSON. Absolutely, Senator. Thank you. Let me make two points about that.

First, there is significant evidence, sir, that right before it becomes public that a company has been the victim of a cyberattack. There are significant spikes in the trading and options, on particular put options, in those companies' stocks. And what that suggests to me, sir, is that there are folks out there who are profiting not just from the cyberattack but by trading on it. And that puts us at risk, that our markets are funding the very cyberattacks that you, sir, are working so hard to help companies stop. That is a deeply concerning kind of insider trading, and this bill would stop it, or rather this bill would make very clear or leave no doubt that the Federal courts, which have expressed some confusion about

this, in fact should conclude that trading on cyberhacked information is a violation of Federal law.

Let me say one other thing, Senator. You asked about foreign companies, and in my testimony today I pointed to very troubling evidence that insiders at Chinese-domiciled firms listed in the United States are trading ahead of very significant stock price declines. In fact, we show, in a new report, sir, that after these sales the stocks of Chinese-domiciled, U.S.-listed firms dropped more than 20 percent. More than $10 billion in losses were avoided by insiders at these firms, by selling in advance of stock price declines, and those losses were borne by American investors.

I think it is crucial that we close these kinds of gaps in our insider trading laws, sir.

Senator WARNER. Two quick comments, and I want to get to my final question for you. One is, this amount of trading that goes on before the public announcement of a cyberattack—and again, we give confidentiality if you report to CISA, so we do not have a mandatory disclosure requirement. Have you been able to measure and actually track that? I mean, I have not followed this thing. I think it is a really relevant point. But have you got some metrics around that?

Mr. JACKSON. Yes, sir. There is an excellent study in the Harvard Business Law Review by Columbia Law School professors Joshua Mitts and Eric Talley, studying the spike in options trading just before a cyberattack is revealed to the public. They detect a very substantial increase in that trading. And because options are levered bets on the changes in stock price, the proceeds from that kind of trading could be very substantial indeed.

Senator WARNER. Well, I think I am going to take a look at that, because it is an area that I am not that familiar with. And candidly, I looked a lot at some of these foreign-domiciled companies that are trading on American exchanges. I am not sure I was fully aware that they were not subject to the same insider trading restrictions, although I was interested to see that at least there was some indication, from China standpoint, that they are going to have these firms finally audited by Western auditors, which I think is a step in the right direction.

As long as I have got you, Mr. Jackson, Professor Jackson, I am just going to talk about how insider trading can also relate to stock repurchasing, stock buybacks. You know, too often I think companies, the management may end up saying, "Aha. We see there is going to be a downturn. Let's go ahead and repurchase stock at a discounted price."

Can you speak to that? I know you have raised this issue as well.

Mr. JACKSON. Yes, sir. I documented, in evidence that I produced while I was still an SEC commissioner, it is very clear from the evidence that insiders at public companies increase their sales of stock in connection with the announcement of a share repurchase plan.

And what I found so troubling about that, sir, is that it is a strange thing for the CEO of the company to say that the stock is cheap enough that we should do a buyback but I would like to sell my shares. It is not my experience that CEOs are in the business of selling their property for cheap.

Because of that, it is very important that there has been some movement in the direction of forcing executives to hold their shares when they engage in a buyback, because, sir, if the idea here is capital allocation, it is not obvious to me why that is the moment the CEO needs to profit on her shares. If the buyback is a good thing for the company in the long run, it should not trouble her at all to hold her shares over an extended period. And I think proposals to that effect are going to be very constructive for our markets.

Senator WARNER. Well I share your concern. I do know if I am defaulting back to Chairman Brown or Senator Tillis, but my time has expired.

Chairman BROWN. Thank you, Senator Warner.

Senator Warren, from Massachusetts, is recognized.

Senator WARREN. Thank you, Mr. Chairman.

So one of the biggest threats to a functioning market is insider trading. When some market participants get special access to information they can use it to take advantage of everyone else. It is cheating, plain and simple, and it is illegal. Even so, it happens.

We have talked a lot today about one kind of market participant, and that is company executives who trade stock based on secret information they have about their businesses. But it can happen in other ways too. Sometimes a high-ranking Government official might know about a change in Government policy that can powerfully affect a corporation.

Professor Jackson, you are one of the Nation's top experts on insider trading, so let me run through some examples with you. If an official, let us say a Member of Congress, learned that the Federal Government was about to award a company a huge, new contract, and then that Senator bought stock in that company before news of that contract was made public. Could that be considered insider trading?

Mr. JACKSON. Yes, Senator, it could.

Senator WARREN. OK. Let us try another one. What about if that Member of Congress attended a top-secret briefing and learned that a company was facing big legal trouble. Could selling their stock before that company made that information public be considered insider trading?

Mr. JACKSON. Yes, Senator, it could.

Senator WARREN. OK. And what if that Member learned in a closed committee meeting of plans to boost the Pentagon's budget by tens of billions of dollars. If that Member bought defense stock, generally, ahead of the markup, could that be considered insider trading?

Mr. JACKSON. Yes, Senator, it could.

Senator WARREN. Let us do one more. What if that Member held drug company stocks and learned from their committee chair that legislation to cut drug prices would be moving in the committee, and if they sold those stocks could that be considered insider trading?

Mr. JACKSON. Yes, Senator, it could.

Senator WARREN. So Members of Congress are in a unique position to obtain information that they can use to gain the stock market. In fact, the risks with Government officials are even higher

than they are with most CEOs, because Government officials can sometimes use their positions to influence private outcomes and the values of the stocks that they hold or trade.

For example, voting on laws that would protect or break up a giant tech company could have a direct impact on the wealth of a Member of Congress who holds stock in giant tech companies.

So look, this is not a hypothetical problem. Last year alone, Members of Congress and their spouses traded more than half-a-billion dollars of stocks and other investments. And here is the most alarming part. On average, Members of Congress came out ahead of the S&P 500, and yet not one single Member was criminally charged with insider trading.

Now there is no doubt in my mind that Members of Congress who break Federal laws by engaging in insider trading should be criminally prosecuted. But there is also no doubt that is not enough to fix the problem. That is already the law.

So let me ask you, Professor Jackson, do we need stronger rules to prevent insider trading in the halls of Congress?

Mr. JACKSON. Yes. This is critical, Senator. When Members are in the business of making decisions that can affect companies at the same time that they have portfolios that could include those very companies, there is a risk of a conflict, and we absolutely need rules to address this, Senator.

Senator WARREN. Thank you. And Professor Coffee, you are also one of the country's leading experts in the area of insider trading. Would you like to weigh in on this?

Mr. COFFEE. Well, I think Professor Jackson was basically relying on the Stock Act, which is a very specific statute. I would point out that with respect to Section 16 here, if this was someone other than a Congressman or a person covered by the Stock Act, it might be impossible to prosecute them because there would be no personal benefit paid for the information, and then he would not be liable under this proposed Section 16, with its personal benefit rule.

But in terms of the broader question you asked, I think you might be suggesting that we should move beyond the criminal law, which is always a blunt sword that could only be occasionally applied, and have Congress impose upon itself some prophylactic rules. It maybe Congress should only invest in diversified portfolios like mutual funds and not own individual stocks. I have heard that idea has been suggested in these halls. I think it is a very good idea.

Senator WARREN. Thank you very much, Professor Coffee.

You know, regardless of how trustworthy Members of Congress might be, trading in individual stocks undermines public confidence in the markets and it undermines public confidence in Congress. And this is why, as Professor Coffee delicately alludes, I have introduced bipartisan legislation with Senator Daines, who is also a Member of this Committee, to ban Members of Congress from owning or trading individual stocks. They can still do the big mutual funds, but not individual stocks. We need to change the rules so that it is 100 percent clear that Members of Congress are not going to be allowed to game the system.

Mr. Chairman, I know that you have introduced legislation to achieve a similar goal, and I look forward to working with you and working on a bipartisan basis. We need to get this done.

Chairman BROWN. I do too. Thank you, Senator Warren.

There are two Republican Senators that are trying to get online, not yet quite ready, Senator Daines and Senator Moran. And Senator Van Hollen, from the Democratic side, from his office, from Maryland. Is he ready?

Senator VAN HOLLEN. I am. Can you hear me?

Chairman BROWN. Go for it. Senator Van Hollen is recognized.

Senator VAN HOLLEN. Thank you, Mr. Chairman. I had hoped to get back to the Committee in person, but good to do it virtually. And I want to thank all the witnesses for their testimony.

Professor Jackson, good to see you again. And as you and I discussed in the past, I have introduced legislation called the 8-K Trading Gap Act, which seeks to close a current gap that we think can lead to mischief in insider trading rules.

As you know, right now public companies are required to disclose significant corporate events to the public within four business days after the event occurs, and they have to do it on a form called an 8-K. This could be for the announcement of clinical trial results for a drug maker, it could be the announcement of a merger with a big competitor, or a big cybersecurity breach that has affected a business' customers.

During this period, market-moving information is known to insiders but not to ordinary investors, and it is a period we call the 8-K trading gap.

So based on your research, is there any reason to believe that executives with access to this material, nonpublic information may be trading within this 4-day window before the news get out to the public?

Mr. JACKSON. Yes, Senator, there is reason to believe that. In a paper released a few years back with coauthors from Harvard and Columbia, I documented that there is significant amounts of insider transactions during the 4-day gap you described.

And, Senator, we also observe that some of the announcements that are pending at the end of that 4-day period are very clearly material corporate events—mergers and acquisitions, balance sheet restructurings, and the like—and yet we see very considerable transactions.

You know, Senator, when we started that study we expected to find very little trading during this period. After all, the company has publicly said that they are going to disclose a material event. We thought that insiders would not trade during this period. We were astonished to see insider trading to this degree.

And I think it points out both the need for your important legislation, to address the 8-K gap, and the need for the legislation before the Committee today that would better deter insiders from engaging in these kinds of transactions.

Senator VAN HOLLEN. Well I appreciate that. I was going to ask, you know, I understand giving companies the 4 days to report on these events, but there certainly does not seem to be any justifiable reason to allow insiders to trade during that period. I assume you agree, based on your previous answer.

Mr. JACKSON. Well that is right, sir. I cannot think of one. I cannot imagine why the company would want its senior management or directors to be trading during the pendency of an announcement that warrants a Form 8-K.

Senator VAN HOLLEN. Now we also need to make sure that American investors are protected on U.S. exchanges in other ways. Obviously insider trading here at home is one. But we also need to deal with foreign corporations, and a couple of years ago Senator Kennedy and I introduced the Holding Foreign Companies Accountable Act. That passed into law, to make sure that all companies listed on U.S. exchanges, whether domiciled in the United States or overseas, had to comply with simple accounting and transparency rules.

I was just looking at a paper that you wrote recently, just in the last couple of days, I believe, on the issue of foreign insiders and their insider trading and how they are not governed by the exact same rules that apply here in the United States. Could you talk a little bit about this?

Mr. JACKSON. Of course. Thank you, Senator, yes. Building on your important legislation on the Holding Foreign Companies Accountable Act, two coauthors from the Wharton School and I just last week released a paper documenting insider trading by foreign firms that are listed in the United States.

We showed, sir, that these insiders, by selling before stock prices fall, avoid billions upon billions of dollars in losses that ordinary American investors have to bear.

There are two important points I want to make about this new study. First is these foreign firms are exempted from the straightforward disclosure that American companies have to provide investors when their insiders engage in trading. That exemption was provided by the SEC decades ago, and I think it is long past time for the SEC to take another look at that, sir. When the provided that exemption, our capital markets were a very different place, and foreign firms raised considerably less money on U.S. exchanges.

Second, it is troubling that these foreign insiders are able to see in this way, and the disclosures that they are providing are provided in paper to the SEC, under long-outdated rules under what is called Rule 144. The idea that there are paper filings sitting in a cabinet at the SEC, sir, with this kind of important information, we have got to fix that.

And so I am hopeful that I will be able to work with both all of you on this Committee and at the SEC to get these rules tightened up, to deter foreign insiders from trading in a way that is unfair to ordinary investors.

Senator VAN HOLLEN. Well thank you for highlighting this issue. Based on your investigation, we are working on legislation to close that unfair situation, and I look forward to being in touch with you about it.

Thank you.

Mr. JACKSON. Thank you, Senator.

Chairman BROWN. Thank you, Senator Van Hollen.

I believe that no one else is returning. We are voting on the Supreme Court today, and voted on a high-level HUD nominee, so I

think I will turn to Senator Toomey for some last remarks and then I will wrap. Thank you.

Senator TOOMEY. Thank you, Mr. Chairman. I just would like to ask unanimous consent to enter into the record letters and statements of support for JOBS Act 4.0, with more than 20 industry and taxpayer advocate associations, including but not limited to the Small Business Investor Alliance, Managed Fund Association, Securities Industries and Financial Markets Association, Natural Venture Capital Association, BIO [phonetic], Small Business and Entrepreneurship Council, AFP, Club for Growth, and the Competitive Enterprise Institute.

Chairman BROWN. Thank you, Senator Toomey. Thank you all, to the witnesses today. I am submitting a statement—without objection, so ordered, his request.

I am submitting a statement for the record by the Maryland Securities Commissioner, Melanie Senter Lubin, President of the North American Securities Administrators Association. Without objection.

For Senators who wish to submit questions for the hearing record those questions are due 1 week from today, Tuesday, April 12th. To the witnesses, please submit your responses to those questions within 45 days of receipt.

Thank you again for your testimony today. The Committee is adjourned.

[Whereupon, at 11:24 a.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

## PREPARED STATEMENT OF CHAIRMAN SHERROD BROWN

The tragedy and uncertainty of the coronavirus pandemic taught us a lot about the economy and the stock market.

At first, for a brief period at the beginning of the pandemic, the stock market tracked what was happening in the rest of the economy. As small businesses and families struggled, U.S. stock market suffered the fastest drop in history, plummeting 34 percent in 33 days.

But then, the stock market had the fastest rebound in history, recovering all of those losses by mid-August.

Meanwhile, small businesses were making impossible decisions about layoffs or shutting their doors altogether. Fourteen million Americans were unemployed.

And last year, we saw record highs in the stock market and all-time records in initial public offerings, private equity, and venture capital.

It was a reminder of what most Americans already know—the stock market is detached from the reality of most people's lives.

And it disproportionately benefits the wealthy. According to Federal Reserve data, the wealthiest one percent hold 53 percent of stock and mutual fund investments, and the bottom 90 percent own less than 12 percent.

Think about that—just one percent of the country holds more than half of all Wall Street assets.

So it's no surprise that most Americans don't trust the markets. They don't think the stock market is fair, and they think the wealthy and well-connected cheat the system.

And too often, they're right. It's why today we're examining how Congress and this Committee must work to crack down on bad actors who cheat the system and cheat Americans planning for the future.

Everyone on Wall Street should play by the same rules. We know that's almost never been the case.

Right now, it seems too easy for corporate insiders out on the golf course to exchange information about upcoming mergers and deals, and get away with it.

All too often we see insiders—from boardrooms to bankers—involved in suspicious trading. These are people who should know better, people who know when they are crossing the line—but they just can't seem to help themselves.

The SEC and the Department of Justice have prosecuted insider trading for decades using principles of fraud under the securities laws. Most of these principles have developed without a standard defined by Congress.

Most people would probably be surprised to learn that there's no one law written down anywhere that spells out what constitutes illegal insider trading.

Over the years, Federal courts have disagreed on what types of misconduct are in fact illegal. And when the Supreme Court has stepped in, instead of resulting in a clearer understanding of the law, it's just created more confusion on what counts as illegal insider trading.

We should all want strict, clear rules on what constitutes illegal insider trading. We should all want a statute that spells out when someone is crossing the line.

That would help avoid this uncertainty and inconsistency.

Since 2014, there's been a debate between the Federal circuit courts and the Supreme Court about when people who provide or receive inside information and trade on it are liable for insider trading.

After the back and forth in those cases, experts still disagree on how much the law changed, where the lines are, and what happens if courts disagree in the future.

We have also seen that there may be limits to our ability to use insider trading case law to hold new varieties of improper trades accountable.

This is especially true with the rise of cyber threats—for example, if someone deliberately hacks into a computer system to access inside information and then trades on it. Existing statutes and case law, believe it or not, don't always treat that as wrongful insider trading, even though to pretty much everyone that sounds like a textbook example.

Our colleagues in the House have been considering these gaps. Representative Himes has been leading on this issue for years, and has pushed legislation that would take away the uncertainty created by the courts and establish standards that address the questions that come up repeatedly. Senator Reed has been working on a Senate version of that House-passed bill that our witnesses will discuss today.

Insider trading cases might not be as cut and dry or as exciting as we see in the movies, but the same kind of misconduct and suspicious trading happens again and again. It's wrong, it's unfair, and it's yet one more way that the wealthy and the well-connected game the system to get ahead.

It's funny how the people who seem to have the best luck playing the stock market so often happened to have friends in high places.

We hear all the time about insiders who have amazing timing and buy stock days before a big announcement, or we read about the chain of people who share a stock "tip," that is clearly confidential information that shouldn't be shared or traded on.

Congress has the opportunity to finally make it clear what the rules are.

A statutory definition of insider trading would also capture abuses and misconduct—like hacking to steal confidential stock information—that courts have found to be outside the concepts of "fraud" and "deception." Even if the hacker accessed the information because of a security weakness, that doesn't mean what they did is okay and it shouldn't mean they can keep their ill-gotten profits.

The measure we are discussing today closes that gap by focusing on "wrongfully" acquired nonpublic information.

Well-connected people buy sophisticated derivatives on a company's stock on a Friday. The following Tuesday the company announces a merger. To most people that doesn't sound like just a lucky bet or a coincidence. That sounds more like a wink and a nod, and a "you scratch my back, I'll scratch yours" understanding.

And when that happens all the time, it's no surprise that most Americans don't think they can trust the market with their retirement savings. For the vast majority of people who get their income from a paycheck, not a brokerage account, they don't see it as a way to make money.

Families saving for the future deserve to know Congress will protect everyone who invests to send their kids to college or to buy a home one day. We must make sure our laws are written down, clear, and apply to everyone, no matter how wealthy and how powerful.

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## PREPARED STATEMENT OF SENATOR PATRICK J. TOOMEY

Thank you, Mr. Chairman.

I will address insider trading, but first I'd like to acknowledge that 10 years ago to this very day, President Obama signed the Jumpstart Our Business Startups, or JOBS, Act into law. This remarkable piece of bipartisan legislation opened new avenues for companies to raise capital. For example, it created a streamlined path for new startups to go public as "emerging growth companies."

Since 2014, these "emerging growth companies" have accounted for almost 90 percent of all initial public offerings, or IPOs. Yet, the number of public companies continues to decrease. In fact, the number of public companies has declined 40 percent since its peak in the late 1990s. If not for the JOBS Act, the situation would be even worse. This decrease hurts economic growth, cuts off funding avenues for American businesses, and reduces investment opportunities for average Americans.

Although the last 2 years saw more IPOs, this may be an aberration if the large number of SPAC offerings turns out to be a temporary phenomenon. And if last week's SEC proposal on SPACs becomes final, we may see the end of SPACs altogether.

But investors have clamored to be part of SPAC offerings. Why is that? My view is that they want growth-stage investments, and they are not getting them any other way.

Companies face excessive costs in going and staying public, which discourages them from going public in the first place. IPOs used to be a capital raising event. Now, they are too often just a liquidity event for early investors.

These costs of going public will increase substantially if the 23 SEC proposals—announced in only the last 4 months and many that significantly uproot the historical approaches taken in securities regulation—go into effect. For a single proposal on climate change, the SEC estimates that it will nearly triple the external costs for companies to prepare their annual 10-K reports. Imagine that.

Think of the money companies spend today on preparing annual reports to cover the entirety of their businesses. And the SEC would nearly triple that cost to add often immaterial disclosure requirements regarding climate change.

In my view, the SEC is taking disclosures in the wrong direction. Unless we change that direction, we could lose America's number one position as the leader in active and efficient capital markets.

That's why yesterday, with my colleagues on the Banking Committee, I have rolled out a discussion draft of the JOBS Act 4.0. This draft is the result of a request I made last February for proposals to increase economic growth and job creation by facilitating capital formation.

In response, we received 35 submissions with more than 150 legislative proposals from a wide variety of bipartisan organizations and stakeholders. We turned a number of these proposals into bills, some of which received bipartisan support.

These bills encourage companies to be publicly traded, particularly during earlier growth stages, improve the market for private capital by appropriately tailoring regulations for small businesses, enhance retail investor access to investment opportunities, and improve regulatory oversight.

We are seeking feedback on this draft over the next 60 days. I am hopeful that Republicans and Democrats can come together and find agreement on the JOBS Act 4.0. This draft acknowledges the important role played by private markets and how they can be improved.

Some resist improving private markets because they claim that doing so would discourage companies from going public. If we want to encourage companies to go public, maybe the answer is to make it less onerous to be a public company.

I don't believe that one of type of market—private or public—is inherently better than the other. Indeed, the optimal source of capital for a company might vary at different stages of its growth cycle. Improved private markets can help private companies stay around long enough to grow into public companies.

However, as the pool of public companies shrinks, retail investors are cut out of key investment opportunities. We should expand retail investor access to these nonpublic investments so they can diversify their portfolios and potentially receive the higher returns available to the wealthy.

We know that union pensions, other institutional investors, and high-net worth individuals routinely include nonpublic investments, such as private equity and venture capital, as a part of their diversified portfolios. We ought to be ensuring that pension plans like CalPERS and wealthy investors aren't the only ones with access to these types of investments.

Now, let me turn to insider trading. The securities markets are at the heart of our economy and our financial system. They reflect the collective decision-making of many individuals on whether to buy, sell, or hold securities. In so doing, they carry out the critical function of price discovery.

An accurate market price—one that efficiently incorporates all available public information—is perhaps the most important investor protection that exists. Thus, it is crucial that market participants have incentives to use lawful means to discover information, conduct analysis, and develop investment hypothesis and to use such efforts to make better decisions about market prices.

For that reason, insider trading has never been about one market participant having better information over another. Instead, insider trading is about one person wrongfully obtaining, or using, material nonpublic information in breach of a fiduciary duty or through misappropriation.

In the decades since the first insider trading cases were brought, the courts have developed an extensive body of insider trading law. It would be preferable for Congress to codify what that law would entail. If we do so, we should be cautious about legislation that might cause confusion, uncertainty, or unintended consequences in this highly technical area, particularly regarding investment research.

I look forward to hearing from today's witnesses about all of these important issues.

**PREPARED STATEMENT OF ROBERT J. JACKSON, JR.**

PIERREPONT FAMILY PROFESSOR OF LAW, NEW YORK UNIVERSITY SCHOOL OF LAW

APRIL 5, 2022

Thank you, Chairman Brown, and thank you, Ranking Member Toomey, for the opportunity to testify before you today. The last time I had the honor of testifying before this Committee, it was at the hearing on my nomination to be a Commissioner of the Securities and Exchange Commission. My Mom and Dad, who grew up in big Irish Catholic families in the Bronx—my mother is one of nine kids, my father one of five—proudly sat behind me that day. The day I was born, nobody in my family had been to college. But my parents plowed their paychecks into the market—and, forty years later, sat behind their son as a Presidential nominee. So to me, markets are important not only because they encourage entrepreneurship and growth. They're important because they make it possible for two middle-class parents to change their son's life. We owe it to families pursuing their version of the American dream—just as mine did—to make sure that when they invest in our markets, they do so on a level playing field.

That's why, after I was confirmed to be Commissioner, I joined Preet Bharara, the former United States Attorney for the Southern District of New York, in calling for a national task force on the law of insider trading.[1] Because Congress has never codified insider-trading rules, both defendants and ordinary investors like my Mom and Dad are exposed to gaps in our law. The task force, which featured a bipartisan group of prosecutors, defense counsel, legal academics and judges, concluded that Congress should clarify the law of insider trading. I agree.[2]

That's why the Insider Trading Prohibition Act you are considering today is so important. The Act addresses key gaps in our outdated, judge-made insider-trading law. For example, the Act would make clear that, in order to hold an insider accountable for leaking information to a trader, prosecutors need not produce a bag of cash delivered to the source in exchange for her secrets. Instead, recognizing that information changes hands in today's markets on the basis of

[1] Preet Bharara & Robert J. Jackson, Jr., *Insider Trading Laws Haven't Kept Up with the Crooks*, N.Y. TIMES (Oct. 9, 2018).

[2] REPORT OF THE BHARARA TASK FORCE ON INSIDER TRADING 20 (January 2020).

more than direct payments, the Act specifies that a direct or indirect personal benefit for the source, including a reputational benefit, is enough.[3] As the task force urged, the Act would focus liability on whether information was wrongfully taken, used, or communicated. And the Act would not purport to be the sole source of liability for insider traders who violate other laws.[4] Defendants whose trading violates more than one federal law should be subject to liability under more than one federal law; in my view, rather than seek solace from Congress, those defendants would be better advised to violate fewer federal laws.

For a detailed and thoughtful analysis of these questions, I commend to the Committee my colleague Professor Coffee's testimony and his writing on this subject. My testimony today will identify two additional gaps in current law that make clear the urgent need for this legislation. First, as explained below, current insider-trading law allows cyber hackers to profit from trading on their activities. Second, as I noted in a study released last week, insiders at foreign firms listed in the United States, and particularly Russian and Chinese firms, profit extensively from their trading—putting American investors at risk.

### I. Cybersecurity and Insider Trading

As this Committee knows too well, our companies are in a constant battle to protect themselves from hackers who seek access to millions of Americans' most private information.[5]

[3] Insider Trading Prohibition Act, 117th Cong., H.R. 2655, Section 2 (providing that a "breach of any fiduciary duty to shareholders of an issuer for a direct or indirect benefit, including" a "reputational benefit" is sufficient to sustain liability).

[4] *See* 18 U.S.C. §§ 1343, 1348; *see also Blaszczak* v. *United States*, 947 F.3d 19 (2d Cir. 2019) (holding that federal wire fraud and securities fraud statutes extend to misappropriation of a government agency's nonpublic information regarding its contemplated rules), *remanded*, *Blaszczak* v. *United States*, 141 S. Ct. 1565.

[5] SEC Commissioner Robert J. Jackson, Jr., *Corporate Governance: On the Front Lines of America's Cyber War* (March 15, 2018) (in 2017, more than 90% of American public companies suffering a cybersecurity breach did not promptly disclose that fact to investors on securities filings). Since then, the SEC has proposed important new rules requiring prompt disclosure of cybersecurity breaches. *See* U.S. Sec. & Exch. Comm'n, Proposed Rule: Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure (March 9, 2022). While those rules, if adopted, will give investors more transparency on cyber breaches, they do not address trading occurring prior to those disclosures—even trading that occurs between the time the company decides to disclose the

There is concerning evidence that these hackers not only attack our companies but also trade before the attack is revealed to the public, raising the prospect that our markets help finance the very cyberattacks that put Americans' privacy at risk.[6]

As it stands today, the law of insider trading often does not cover that activity. The reason is that establishing insider-trading liability under current law generally requires the government to show that information was obtained in breach of a duty or by way of deception.[7] Many hackers, however, attack our companies not through deception but by brute-force tactics that simply overwhelm our defenses.[8] From the perspective of the judges who have made our insider-trading law, that distinction might make a difference—but for ordinary investors like my Mom and Dad, the idea that the law of insider trading allows hackers to profit from the destruction they cause raises doubts about the fundamental fairness of our markets.

The Act would close that gap. Among the "most significant impact[s]" of the law, according to practitioners, would be to clearly outlaw trading on information obtained through cybersecurity hacks.[9] I cannot see how the current lack of clarity on that question benefits American investors, companies or markets. Indeed, even those focused on preserving the price-accuracy benefits of informed trading should support outlawing trading of this kind.

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hack and the filing of the disclosure. *See* Alma Cohen, Joshua Mitts & Robert J. Jackson, Jr., *The 8-K Trading Gap* (2015) (documenting trading between the time firms decide to make a disclosure and the disclosure's filing).

[6] *See* Joshua Mitts & Eric Talley, *Informed Trading and Cybersecurity Breaches*, 9 HARV. BUS. L. REV. 1 (2019) ("[O]ur findings appear strongly consistent with the proposition that arbitrageurs can and do obtain early notice of impending [cyber] breach disclosures, and that they are able to profit from such information.").

[7] 15 U.S.C. § 78j(b) (forbidding the use of any "manipulative or deceptive device or contrivance in contravention of such rules as the [SEC] may prescribe"); *see also* 17 C.F.R. § 240.10b-5; *United States* v. *O'Hagan*, 521 U.S. 642 (1997).

[8] *SEC* v. *Dorozhko*, 574 F.3d 42, 47 (2d Cir. 2009) ("In our view, misrepresenting one's identify in order to gain access to information that is otherwise off limits, and then stealing that information is plainly 'deceptive' within the ordinary meaning of the word. It is unclear, however, that exploiting a weakness in an electronic code to gain unauthorized access is 'deceptive,' rather than being mere theft.").

[9] *See* Insider Trading Prohibition Act, 117th Cong., H.R. 2655, Section 2 (prohibiting trading based on information "obtained by" "a violation of any Federal law protecting computer data" or "the intellectual property or privacy of computer users"); *see also* DAVIS POLK, CLIENT MEMORANDUM: HOUSE PASSES INSIDER TRADING BILL (May 25, 2021) ("Perhaps the most significant impact [of the Act] would be to cover hacking . . . without regard to whether the hacking method involved 'deceptive' conduct.").

To see why, note that the prospect of profiting from trading on an event can give the trader incentives to prefer that the event occur. In a typical informed-trading case, profits give traders incentives to invest in discovering information.[10] But in the cybersecurity context, allowing traders to profit from hacked information gives them incentives to invest in hacking. There is no reason to think that those incentives are productive for American investors or companies—yet current law leaves open the question whether such trading is illegal.[11]

Closing gaps in our insider-trading law is all the more urgent in today's fast-moving markets, where traders are constantly searching for advantages against ordinary investors. Indeed, in a study released just last week, my coauthors and I examine another such gap: insider trading by executives at foreign firms listed in the United States.

### II. INSIDER TRADING AT FOREIGN FIRMS LISTED IN THE UNITED STATES

Gaps in our insider-trading law expose investors like my Mom and Dad to opportunistic behavior by market actors not only here in the United States but around the world. The reason is that foreign companies domiciled in countries like China and Russia now raise significant funds from American investors by listing on U.S. stock exchanges.[12] Unlike executives at American corporations, however, insiders at foreign firms are not subject to prompt disclosure of transactions in their company's stock.[13] I wondered whether our outdated insider-trading law

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[10] *See, e.g.*, JONATHAN R. MACEY, INSIDER TRADING: ECONOMICS, POLITICS, AND POLICY 21-47 (1991).

[11] Matt Levine, *Is Cyber-Insider Trading Illegal?*,BLOOMBERG VIEW: MONEY STUFF (2018) (noting that even sophisticated observers do not know the answer to his title's question).

[12] As a formal matter, these firms often list on U.S. Exchanges by way of American Depository Receipts or American Depository Shares, which generally represent an interest in the shares of a company domiciled outside the United States that have been deposited with a U.S. bank or trust.

[13] Under Section 16(a) of the Securities Exchange Act of 1934, officers and directors of U.S. public companies are required to publicly disclose certain transactions in their company's stock on the SEC's Form 4. In 2002, Congress passed the Sarbanes-Oxley Act, mandating that insiders at U.S. companies report their trades under Section 16(a) within two business days and file Form 4 electronically. U.S. Sec. & Exch. Comm'n, Final Rule, Ownership Reports and Trading by Officers, Directors and Principal Security Holders (2002). But the SEC had previously exempted foreign private issuers from the disclosure requirements of Section 16(a). 17 C.F.R. § 240.3a12-3(b). Thus, insiders at foreign-domiciled firms traded on U.S. stock exchanges were not subject to the more strict insider-trading disclosure requirements imposed by Sarbanes-Oxley.

gives foreign-firm insiders unique freedom to engage in opportunistic trading.

So Daniel Taylor and Bradford Lynch of the Wharton School and I dug into the data.[14] Drawing on a unique dataset based on tens of thousands of paper filings with the SEC describing sales of stock over a five-year period, we study whether foreign-firm insiders are able to avoid losses on their U.S.-traded stocks by selling in advance of price declines.[15]

The results are striking. Our data provide systematic evidence that foreign-firm insiders avoid substantial losses by selling shares before stock-price declines. And this activity is concentrated in firms domiciled in just a few countries overseas. Figure 1 below documents the median returns, by country of domicile, at foreign firms listed in the United States during the twelve months after the insider sales we see:

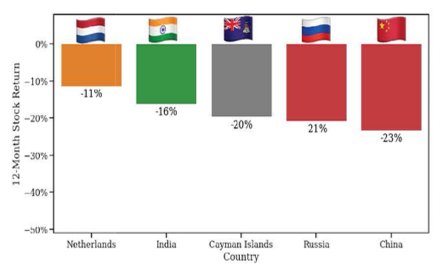


FIGURE 1. MEDIAN TWELVE-MONTH STOCK RETURNS AFTER INSIDER SALES.

When insiders of U.S.-listed Chinese companies sell shares, the median company's stock price falls by 23% in the twelve months after the sale. And when insiders at U.S.-listed Russian firms sell, the median firm's stock declines 21% in the next twelve months.These results reflect

[14] *See* Robert J. Jackson, Jr., Bradford Lynch & Daniel J. Taylor, *Holding Foreign Insiders Accountable* (April 2022).

[15] *Id.* at 4. Although foreign-firm insiders are not required to file Form 4 under Section 16 of the Securities Exchange Act of 1934 as insiders at U.S.-domiciled public companies generally must, their stock sales may require them to file Form 144, providing a rare window into foreign-firm insider trading. Unlike Form 4, however, Form 144 is not required to be filed either speedily or electronically. Indeed, during the 2019 calendar year alone, the SEC received over 31,000 Form 144 filings, over 99% of which were filed on paper and mailed to the SEC. *See* U.S. Sec. & Exch. Comm'n, Proposed Rule: Rule 144 Holding Period and Form 144 Filings, at 122 (2020).

foreign-firms' insiders ability to avoid significant losses by selling prior to substantial stock-price declines. They are especially striking when contrasted with the returns that follow stock sales by executives at American companies, who generally do not sell before prices fall.[16]

Our study also shows that foreign-firm insiders avoid significant losses in dollar terms by selling when they do. Indeed, we estimate that insiders at Chinese-domiciled, U.S.-listed companies have avoided over $10 billion in losses as a result of well-timed stock sales:

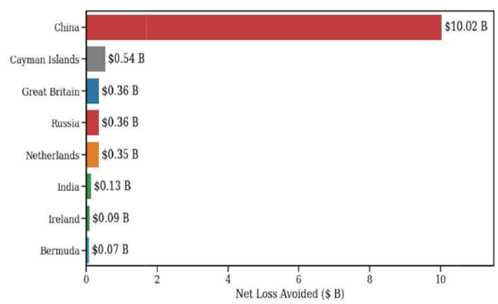


FIGURE 2. INSIDERS' NET DOLLAR LOSS AVOIDANCE BY COUNTRY OF DOMICILE.

From the perspective of ordinary investors like my parents, this evidence raises serious questions about the law of insider trading. For one thing, it is far from clear why foreign-firm insiders should be playing by a different set of rules than their American-company counterparts, who must disclose their trades promptly to investors.[17] To be sure, there are good reasons to want

[16] *See* Alan D. Jagolinzer, David F. Larcker & Daniel J. Taylor, *Corporate Governance and the Information Content of Insider Trades*, 49 J. ACCT. RSCH. 1249 (2011); Alan D. Jagolinzer, David F. Larcker, Gaizka Ormazabal & Daniel J. Taylor, *Political Connections and the Informativeness of Insider Trades*, 75 J. FIN. 1833 (2020); *see also* Jackson, Lynch & Taylor, *supra* note 14, at 2 (confirming this result in the Form 144 sample for insiders at U.S.-domiciled firms).

[17] The SEC exempted foreign private issuers from these requirements decades ago in an effort to encourage those issuers to list on U.S. exchanges. *See* Sec. & Exch. Comm'n, *supra* note 13; Steven Davidoff, *Rhetoric and Reality: A Historical Perspective on the Regulation of Foreign Private Issuers*, 79 U. CIN. L. REV. 619, 621 (2011). But several changes since that time warrant reconsideration of that decision. First, when the SEC adopted that position, American insiders were not yet subject to the more strict disclosure requirements imposed by the Sarbanes-Oxley Act, so the comparative advantage given to foreign-firm insiders was not as large as it is now. Second, far fewer foreign firms were then listed on U.S. exchanges. Third, even fewer foreign firms were domiciled in countries, like China, where many proscriptions and protections of federal securities laws cannot reach. *See* Jesse M.

to make our markets attractive places to raise capital for companies around the world. But we neither can nor should achieve that by making it easier for foreign-firm insiders to trade in the dark—and avoid losses that ordinary American investors must bear.

For another, there is longstanding evidence that increasing transparency around trading reduces insiders' opportunities to take advantage of investors.[18] Exempting foreign-firm executives from rules governing the transparency of insider trades is the kind of gap in our law that we must close to protect Americans' confidence in the fairness of our markets. That's why the SEC should reconsider foreign firms' exemption from the insider-trading disclosure rules that American companies must follow under Section 16 of the Exchange Act. And, if necessary, Congress should make clear to the SEC that requiring transparency of foreign-firm insider trading should be a priority.

For decades, the judge-made law governing insider trading has left gaps inviting insiders to take advantage of ordinary investors. Congress should make clear that all participants in American capital markets must play by the same rules. Thank you once again for the opportunity to testify before you today. I would be delighted to answer any questions you might have.

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Fried & Ehud Kamar, *China and the Rise of Law-Proof Insiders* (EGCI Working Paper No. 557/2020) (referring to such insiders as "law-proof"). Today, in light of the fact that billions of dollars of American investors' money are invested in firms domiciled in countries that render those companies law-proof, the case for enhanced transparency around their insiders' trading is much stronger.

[18] Bradford Lynch Levy, *Hidden Disclosure and the Market for Information* (Wharton School doctoral thesis, January 2022) (finding that Form 144 filings "serve important valuation and monitoring roles, but only after the SEC begins electronic dissemination, suggesting that the private market for information is unable to replicate the effects of public dissemination"); *see also* Francois Brochet, *Information Content of Insider Trades Before and After the Sarbanes-Oxley Act*, 85 ACCT. REV. 419 (2010); Robert J. Jackson, Jr., *Stock Unloading and Banker Incentives*, 112 COLUM. L. REV. 951 (2012) (documenting, in a rare setting where insiders are occasionally subject to Section 16 and occasionally not, the marginal effects of applying Section 16 to insiders' trading activity).

## PREPARED STATEMENT OF M. TODD HENDERSON

MICHAEL J. MARKS PROFESSOR OF LAW, UNIVERSITY OF CHICAGO LAW SCHOOL

APRIL 5, 2022

Mr. Chairman and Members of the Committee, thank you for having me testify on the topic of the regulation of capital raising and insider trading. These issues are at the heart of our economy. Every company has to raise money, and laws and regulations have a tremendous impact on how this is done and, most importantly, how much it costs. It is easy and maybe politically appealing to add more and more obligations on companies, but costs of compliance don't fall just on rich investors or abstract companies—they are paid for by every American. While we need some laws to prevent fraud and to ensure accurate disclosure of information, every dollar spent on complying with regulations is a dollar not spent on employing workers, investing in research and development, and in bringing products and services to everyday Americans. The goal of law should be to obligate companies to spend no more than is absolutely necessary to protect investors and ensure robust capital markets. After all, we as a society pay the costs of regulation, and we should be willing to do so only if the return exceeds that cost.

There is no real question that the costs of fundraising are too high today. The burdens of complying with securities disclosures are many times higher than they were just a few decades ago. To give just one example, consider the disclosure obligations under Regulation S-K. This regulation has 102 specific items of disclosure set forth in over 140,000 words on 385 pages of the Code of Federal Regulations—the rules have grown twenty-fold in length since 1980. This means lots of lawyers can find work, but fewer engineers, chemists, and others who actually discover things that improve our world.

Moreover, the risks of meritless securities fraud suits remains high, notwithstanding efforts by Congress to eliminate them. The result has been a sharp drop in the number of public companies and the number of companies going public. There are about half as many public companies today as there were in 2000. Companies are also resorting to new means of access public equity—such as SPACs—as a work around of the costs of going public. While the verdict is still out on SPACs, the fact that such innovation is viewed as necessary by investors and companies should give regulators pause before piling on new costs of going public through traditional means.

Instead of trying to reduce the burdens on public companies, the SEC is doubling down, issuing proposed rules that will straddle shareholders, workers, and customers with even more costs. At the same time, it is hampering the ability of all Americans to invest in private markets. Private companies are an important alternative to public ones, and returns in the private equity market and other alternative asset classes have been superior to public returns in recent decades. Private equity provides not only an important investment option for investors of all kinds, but it helps turn around struggling companies, offers all companies an alternative governance approach that can fit their needs at particular times, and, most importantly, provides discipline against public-company managers that may act in a self-serving way. Congress and the SEC should expand the opportunity of every investor to access private equity and other asset classes, consistent with fiduciary duty obligations under ERISA and other laws.

Let me turn briefly to insider trading. When talking about insider trading, it is important to put aside conventional wisdom on the topic. There is nothing unlawful about trading based on "material nonpublic information" about a company. Investment advisors and stock market analysts make their living seeking information advantages for their clients. Without these incentives, there will be less information about stock prices, which means they will be less accurate. The consequence will be that capital will not be allocated to where it is most valuable. This harms everyone, not just investors.

Insider trading based on an information advantage is only illegal when it results in a violation of the antifraud provisions of the Federal securities laws. Under existing case law, that generally happens when a corporate insider trades on material nonpublic information for his or her own benefit, when someone deceptively takes material nonpublic information that does not belong to them and uses it to trade, or when these individuals provide—as a "tipper"—the material nonpublic information to someone else to trade on in return for a personal benefit. Justice Ginsburg made this property-based approach clear in her opinion in United States v. O'Hagan.

The Insider Trading Protection Act purports to merely codify our existing insider trading prohibitions. But the actual effect of ITPA would be to increase uncertainty

for the analysts and traders that do the essential work of incorporating information into stock prices. When law professors can turn everyday scenarios—such as overheard conversations about deals and documents left in the back of airplane seat pockets—into challenging hypotheticals for law school exams, the result is a huge chilling effect on the work necessary to ensure accurate stock prices.

This means not only the potential for capital misallocation, but also large compliance costs for investment funds. Importantly, these costs of ensuring investment professionals do not violate the law will fall disproportionately on smaller and midsized investment funds. To make matters worse, these funds are more likely to be owned and operated by minorities and women, and to be the ones taking alternative positions on matters related to ESG and other matters.

There are several problems with the ITPA in its current form.

First, ITPA codifies the existing personal benefit requirement for a tipper, but includes an "indirect personal benefit." It is possible to describe virtually any human interaction as providing an "indirect benefit" to the participants. Instead, the law should reflect the commonsense notion that the source of information either received something tangible and valuable in return or provided what amounts to a monetary gift to a relative or friend.

Second, ITPA uncontroversially states that trading on information wrongfully obtained or communicated as a result of theft, deception, or a breach of fiduciary duty will lead to liability. It also contains a catchall provision, however, extending the concept to "a breach of a confidentiality agreement, a breach of contract, or a breach of any other personal or other relationship of trust and confidence." This is a system ripe for abuse, with companies potentially able to prevent individual investors from trading merely by providing them with information whether they want it or not.

Third, ITPA expands the types of traders who can be held liable for insider trading. Currently, a trader has to act with some form of intent to violate the law. Under the bill, however, anyone who "was aware, consciously avoided being aware, or recklessly disregarded" that the information was wrongfully obtained or communicated can have a case brought against them. ITPA is silent on the meaning of "recklessly disregarded," which would appear to rope in innocent traders along with actual wrongdoers.

Finally, ITPA does not contain an exclusivity clause stating that it will be the sole basis for bringing Federal insider trading claims. Allowing prosecutors to cherry pick their preferred law is no way to provide clear rules for the market. Indeed, there is a Federal statute that allows the Department of Justice to bring criminal insider trading claims without having to demonstrate the existence of a personal benefit. So much for ITPA's personal benefit provision.

There is little dispute that the knowing use of material nonpublic information obtained in clearly illicit ways to reap securities trading gains—commonly known as "stealing"—is what the Government should be trying to prevent. At the same time, we do not want to chill the valuable communications that go on between company insiders and market participants, which provide investors with important real-time information about their investments. ITPA is an opportunity for Congress to establish insider trading prohibitions with a clear set of limited rules that the Government and investors alike can easily follow.

To that end, Congress needs—at a minimum—to narrowly define "personal benefit," drop the catchall provision as to how information can be wrongfully obtained or communicated, limit liability to individuals with actual knowledge of their wrongdoing, and make ITPA the exclusive basis for Federal insider trading claims.

Thank you.

# PREPARED STATEMENT OF DAVID R. BURTON

SENIOR FELLOW IN ECONOMIC POLICY, ROE INSTITUTE FOR ECONOMIC POLICY STUDIES, THE HERITAGE FOUNDATION

APRIL 5, 2022

My name is David R. Burton. I am Senior Fellow in Economic Policy at The Heritage Foundation. I would like to express my thanks to Chairman Brown, Ranking Member Toomey, and members of the committee for the opportunity to be here this morning. The views I express in this testimony are my own and should not be construed as representing any official position of The Heritage Foundation.

Because today is the $10^{th}$ anniversary of the JOBS Act, a bi-partisan achievement of major significance, I have been asked to focus on entrepreneurial capital formation issues in my testimony. Specifically, my testimony addresses (1) the importance of the JOBS Act, (2) the importance of entrepreneurial capital formation to the economy and the American people, (3) the impact of regulatory impediments to entrepreneurial capital formation, (4) legislative proposals that have been introduced this Congress that promote capital formation and which have been incorporated into the Senate Banking Committee Republicans' JOBS Act 4.0 discussion draft, (5) additional statutory changes that would improve entrepreneurs' access to capital and (6) more fundamental reforms to our securities laws that would substantially improve the regulatory environment for both entrepreneurs and larger public companies and the returns to investors.

I would also like to note that the process that is underway should be a model of how to develop legislation. It has involved a request for detailed public input about how to solve evident problems,[1] followed by the release of a public discussion draft for people to evaluate and offer constructive feedback on actual legislative language. This will presumably be followed by actual legislation, hearings and a markup where amendments may be offered. This process will result in well thought out, publicly vetted legislation that has been improved by public input and will more effectively solve problems.

***The Importance of the JOBS Act***

Passed with large bipartisan majorities and signed into law by President Obama, the 2012 JOBS Act[2] was a bipartisan achievement of consequence.[3] It substantially improved the laws governing entrepreneurial capital formation.[4] As discussed throughout this testimony, the JOBS Act has had a measurable positive impact on entrepreneurial capital formation.

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[1] "Toomey Requests Proposals to Foster Economic Growth and Capital Formation," Press Release, February 2, 2021 https://www.toomey.senate.gov/newsroom/press-releases/toomey-requests-proposals-to-foster-economic-growth-and-capital-formation. See also, "Submissions," Committee on Banking, Housing and Urban Affairs, United States Senate https://www.banking.senate.gov/resources/data-submissions.

[2] Jumpstart Our Business Startups Act, Public Law 112–106, April 5, 2012, http://www.gpo.gov/fdsys/pkg/PLAW-112publ106/pdf/PLAW-112publ106.pdf.

[3] H.R. 3606 (112th Cong.) passed the House with overwhelming support, 390 to 23: Final Vote Results for Roll Call 110, H.R. 3606, Recorded Vote, March 8, 2012, https://clerk.house.gov/Votes/2012110?Page=1&RollCallNum=110, and passed the Senate by a wide margin, 73 to 26: U.S. Senate Roll Call Votes 112th Congress–2nd Session, H.R. 3606, March 22, 2012, http://www.senate.gov/legislative/LIS/roll_call_lists/roll_call_vote_cfm.cfm?congress=112&session=2&vote=00055.

[4] See, e.g., David R. Burton, "Improving Entrepreneurs' Access to Capital: Vital for Economic Growth," Heritage Foundation Backgrounder No. 3182, February 14, 2017 https://www.heritage.org/sites/default/files/2017-02/BG3182.pdf; Thaya Brook Knight, "A Walk Through the JOBS Act of 2012: Deregulation in the Wake of Financial Crisis," Cato Institute Policy Analysis 790, May 3, 2016 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2833877#.

Legislative changes as the bill progressed through Congress, however, limited the positive impact. Regulatory decisions by the SEC further limited the economic gains from the Act. A series of relatively modest improvements effective March 15, 2021[5] will reduce the adverse impact of these regulatory decisions to some degree over time. The most notable improvements by this rulemaking include the clarification of the integration doctrine and increases in the Regulation A, Regulation CF and Rule 504 offering limitation amounts but there were other improvements. The adverse impact of the original legislative decisions as the JOBS Act progressed through Congress and regulatory decisions made by the Commission when implementing the JOBS Act was particularly pronounced with respect to Title III crowdfunding but also substantial with respect to the small issues exemption (Regulation A) and what became Rule 506(c) relating to general solicitation in Regulation D offerings.

The changes made by the JOBS Act fall into five categories. Those relating to:

(1) smaller public "emerging growth companies" or EGCs (Title I),
(2) general solicitation under Regulation D (Title II),
(3) crowdfunding (Title III),
(4) an improved small issues exemption (often called Regulation A+) (Title IV), and
(5) changes to the registration threshold allowing more companies to remain private (Titles V and VI).

### 1. *Title I: Emerging Growth Companies*

Title I of the JOBS Act – sometimes called the IPO On-Ramp – created a new concept of "emerging growth companies (EGCs)."[6] Generally, a company qualifies as an emerging growth company if it has total annual gross revenues of less than $1.07 billion[7] during its most recently completed fiscal year and, as of December 8, 2011, had not sold common equity securities under a registration statement. For five years, EGC's are excused from complying with a number of onerous disclosure requirements and from Sarbanes-Oxley Act Section 404(b) internal control reporting requirements. Moreover, they are permitted to communicate with institutional accredited investors or qualified institutional buyers prior to or after the filing of the registration statement.[8] Title I also permitted EGCs to submit confidential draft registration statement to the SEC for

[5] "Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets," Final Rule, Securities and Exchange Commission, *Federal Register*, Vol. 86, No. 9, January 14, 2021, pp. 3496-3605 https://www.govinfo.gov/content/pkg/FR-2021-01-14/pdf/2020-24749.pdf. A summary in reasonably plain English of the changes made by this rule is available at "A Small Entity Compliance Guide," Securities and Exchange Commission, March 10, 2021 https://www.sec.gov/corpfin/facilitating-capital-formation-secg.

[6] Section 2(a)(19) of the Securities Act of 1933 (15 USC 77b(a)(19)). See also, "Emerging Growth Companies," Securities and Exchange Commission https://www.sec.gov/smallbusiness/goingpublic/EGC.

[7] Originally $1 billion.

[8] Section 5(d) of the Securities Act of 1933.

review.[9] The ability to submit a confidential draft registration statement has now been generalized by the SEC.[10]

*2. Title II: General Solicitation and Title II Secondary Markets*

Title II eliminated the prohibition against general solicitation or general advertising for Regulation D Rule 506 offerings, provided that all purchasers of the securities are accredited investors and that the issuer takes "reasonable steps to verify" that purchasers of the securities are accredited investors.[11]

Title II also provided an exemption from broker-dealer registration for platforms that facilitate trading of Regulation D securities provided that the platforms meet certain requirements.[12] This provision is of limited value since the platforms are barred from taking compensation in connection with the purchase or sale of securities via the platform.[13] These platforms have grown rapidly since the passage of the JOBS Act although it is far from clear that this provision in the JOBS Act is the reason. Most are presumably relying on other exemptions (such as 4(a)(1-½) and the post JOBS Act Securities Act section 4(a)(7)).[14]

*3. Title III: Crowdfunding*

Title III established the framework for a new crowdfunding exemption.[15] Issuers may now offer up to $5 million in securities annually using this exemption. It was originally $1 million. Investors, other than accredited investors,[16] may not invest in any offering more than (i) the greater of $2,200 or 5 percent of the annual income or net worth of the investor if either the annual income or the net worth of the investor is less than $107,000[17] or (ii) 10 percent of the annual income or net worth of such investor if either the annual income or net worth of the investor is equal to or more

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[9] Section 6(e) of the Securities Act of 1933 (15 USC 77f(e)).

[10] "Draft Registration Statement Processing Procedures Expanded," Securities and Exchange Commission, June 29, 2017 [supplemented August 17, 2017 and June 24, 2020] https://www.sec.gov/corpfin/announcement/draft-registration-statement-processing-procedures-expanded.

[11] Securities Act section 4(b) [15 USC 77d(b)]; JOBS Act section 201(a)(1); "Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings," Final Rule, *Federal Register*, Vol. 78, No. 142, July 24, 2013, p. 44771 http://www.gpo.gov/fdsys/pkg/FR-2013-07-24/pdf/2013-16883.pdf. See also comment letter of David R. Burton regarding "Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings," October 5, 2012 http://www.sec.gov/comments/s7-07-12/s70712-118.pdf.

[12] Securities Act section 4(b) [15 USC 77d(b)]; JOBS Act section 201(c).

[13] Frequently Asked Questions About the Exemption from Broker-Dealer Registration in Title II of the JOBS Act," Question 5, February 5, 2013, https://www.sec.gov/divisions/marketreg/exemption-broker-dealer-registration-jobs-act-faq.htm.

[14] Title LXXVI, Section 76001 of the Fixing America's Surface Transportation Act, Public Law 114–94, December 4, 2015, creates a new exemption at Securities Act, Section 4(a)(7).

[15] See Regulation CF for details.

[16] This non-application of the limitation with respect to accredited investors was not in the original JOBS Act as passed but was added by the 2021 Regulation CF amendments included in "Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets," Final Rule, Securities and Exchange Commission, *Federal Register*, Vol. 86, No. 9, January 14, 2021, pp. 3496-3605 https://www.govinfo.gov/content/pkg/FR-2021-01-14/pdf/2020-24749.pdf.

[17] Securities Act section 4(a)(6)(B)(i). Note: This amount has been adjusted for inflation since the JOBS Act.

than $107,000.[18] The total amount invested may not exceed $107,000.[19] The crowdfunding offering must be conducted through a broker-dealer or funding portal. Both the issuer and intermediary must comply with numerous requirements. The disclosure requirements imposed by statute and the even more costly requirements imposed by the SEC are sufficiently costly that when the offerings were limited to $1 million, crowdfunding offerings were largely uneconomic and crowdfunding, as I and a few others predicted, did not achieve its promise.[20] Similarly, the regulatory imposition on crowdfunding portals has made the operation of such portals largely unprofitable. The 2021 revisions to Regulation CF may help alleviate these problems but the changes made were sufficiently modest that any kind of major increase in Title III crowdfunding is unlikely.

*4. Title IV: Regulation A Plus*

The Commission had very nearly killed Regulation A prior to the JOBS Act.[21] In 2011, the year before the JOBS Act, only one Regulation A offering was completed.[22] Title IV created what has come to be known as "Regulation A plus" or "Regulation A+." It added a new small issues exemption under which issuers could raise up to $50 million in a public offering and sell unrestricted securities subject to such initial and continuing disclosure requirements as the Commission may determine.[23] This has now been increased to $75 million for so-called Tier 2 offerings. The Commission in its implementation of this Title made some significant errors. The most notable is that blue sky registration and qualification requirements are only preempted for primary Tier 2 offerings.[24] Secondary offerings of securities purchased in Tier 2 offerings and all Tier 1 securities sales are subject to state registration and qualification requirements. As discussed more fully below, this seriously impedes the ability of secondary markets to develop in Regulation A securities. This harms investors by making Regulation A securities illiquid and reducing the price these securities can command when resold. This, in turn, has an adverse impact on primary offerings because investors know that reselling the securities will be more difficult.

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[18] Securities Act section 4(a)(6)(B)(ii). Note: This amount has been adjusted for inflation since the JOBS Act.
[19] Ibid. Note: This amount has been adjusted for inflation since the JOBS Act.
[20] Proposed Rules, "Crowdfunding," *Federal Register*, Vol. 78, No. 214, November 5, 2013, p. 66428 [Release Nos. 33-9470 and 34-70741; File No. S7-09-13] http://www.gpo.gov/fdsys/pkg/FR-2013-11-05/pdf/2013-25355.pdf; Comment letter of David R. Burton regarding Crowdfunding, February 3, 2014 http://www.sec.gov/comments/s7-09-13/s70913-192.pdf; Comment letter of Rutheford B Campbell, Jr., regarding Crowdfunding, February 14, 2014 http://www.sec.gov/comments/s7-09-13/s70913-278.pdf. See also, *Crowdfunding: A Guide to Raising Capital on the Internet*, Steven Dresner, Editor (Wiley: 2014).
[21] See Rutheford B Campbell, Jr., "Regulation A: Small Businesses' Search for a Moderate Capital," *Delaware Journal of Corporate Law*, Vol. 31, pp. 71-123 (2006) https://uknowledge.uky.edu/cgi/viewcontent.cgi?article=1125&context=law_facpub; Stuart R. Cohn and Gregory C. Yadley, "Capital Offense: The SEC's Continuing Failure to Address Small Business Financing Concerns," 4 *NYU Journal of Law and Business*, Vol 4, pp. 1-87 (Fall 2007) https://scholarship.law.ufl.edu/cgi/viewcontent.cgi?article=1257&context=facultypub.
[22] "Factors That May Affect Trends in Regulation A Offerings," United States Government Accountability Office, July 2012 (GAO-12-839).
[23] JOBS Act section 401.
[24] 17 CFR § 230.256.

*5. Allowing More Firms to Remain Private or Quasi-Public*

Titles V and VI increased the number of holders of record a firm can have before being required to register under section 12(g) of the Securities Exchange Act from 500 persons to 2,000 investors or 500 non-accredited investors.[25] Title V also excluded from the count securities held by persons who received the securities pursuant to an employee compensation plan.[26] Some of these firms are "truly" private in that the shares are held primarily or entirely by accredited investors and the shares are restricted securities. Others are "quasi-public" in that the shares were sold to and are held by "the public" (i.e. many non-accredited investors) and the shares are not restricted securities although the issuer is not a reporting company.

*6. Economic Impact of the JOBS Act*

The JOBS Act has improved entrepreneurs' access to capital. But it has not been an unqualified success because mistakes were made in the legislative process. Additional mistakes were made by the SEC as it implemented the JOBS Act. Some, but by no means all, of these regulatory mistakes were corrected by the SEC in a rule effective March 15, 2021.[27]

As discussed below in detail, Title I of the JOBS Act has been a major contributing factor in arresting the precipitous decline in IPOs that was occurring prior to enactment of the JOBS Act. Title II of the JOBS Act (relating to general solicitation in Regulation D offerings) was one of the most underappreciated aspects, by many, of the JOBS Act. It is now legal for a company to put an advertisement in a newspaper or on-line indicating that the issuer is looking for rich people to invest in the issuer. It has been a major success. Title III Crowdfunding (Regulation CF) has been largely a failure. Only $55-65 million (with an 'm') are raised this way each year. That is 2/1000ths of a percent of the private capital raised each year. Given the piling on by Congress and the Commission of ever more regulatory requirements on these tiny issuers, this was entirely predictable and, in fact, was predicted by me and a few others.[28] Regulation A plus is a minor success. About a billion dollars annually is raised this way. But with some changes, it could become a major means of raising entrepreneurial capital.

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[25] JOBS Act section 501.
[26] JOBS Act sections 502-503.
[27] November 2, 2020
Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets Final rule
Federal Register / Vol. 86, No. 9 / Thursday, January 14, 2021 / 3496-3605
[28] Comment letter of David R. Burton regarding Crowdfunding, February 3, 2014 http://www.sec.gov/comments/s7-09-13/s70913-192.pdf ("If, however, the regulatory costs associated with crowdfunding are too high, then issuers will either use other means to raise capital or be unable to raise capital and ordinary investors will be denied the opportunity to make these investments. Firms using crowdfunding will almost invariably be the smallest of small businesses. More established firms or those seeking more than $1 million will use Regulation D or, perhaps, Regulation A+. If the Commission overregulates crowdfunding, it will frustrate the bi-partisan intention of Congress and the President and impede both the ability of small firms to raise the capital they need to create jobs, innovate and contribute to the prosperity of the country and the ability of small investors to invest in the firms with the most potential growth. This is no idle possibility."). See also Comment letter of Rutheford B Campbell, Jr., regarding Crowdfunding, February 14, 2014 http://www.sec.gov/comments/s7-09-13/s70913-278.pdf.

In all, as the tables below show, JOBS Act offerings amount to about three to seven percent of the private capital raised in the U.S. The Title I EGC provisions account for more (although raised in the public market). Although I do not have a good answer to how much additional capital was raised due to these EGC provisions, the graph in the EGC discussion below is quite remarkable. The number of public companies was in a free fall prior to the JOBS Act. Now that number is basically flat. The number of IPOs in the nine years after the JOBS Act has increased by 43 percent relative to the nine years before the JOBS Act and the amount raised has increased by 57 percent.[29] Precisely how much of that is attributable to Title I, I am not sure. See the Table in the EGC section below for the IPO data.

Amounts Raised in the Exempt Market in 2018 ($ billions)[30]

| Exemption | Amount Raised | Percentage of Total |
|---|---|---|
| Rule 506(b) of Regulation D | $ 1,500 | 51.48% |
| **Rule 506(c) of Regulation D** | **$ 211** | **7.24%** |
| Rule 504 of Regulation D | $ 2 | 0.07% |
| Regulation D Subtotal | $ 1,713 | 58.79% |
| **Regulation A: Tier 1** | **$ 0.061** | **0.00%** |
| **Regulation A: Tier 2** | **$ 0.675** | **0.02%** |
| **Regulation A Subtotal** | **$ 0.736** | **0.03%** |
| **Regulation Crowdfunding; Section 4(a)(6)** | **$ 0.055** | **0.00%** |
| Other exempt offerings | $ 1,200 | 41.18% |
| Total | $ 2,913.791 | 100.00% |
| **JOBS Act Offerings** | **$ 211.791** | **7.27%** |

Amounts Raised in the Exempt Market in 2019 ($ billions)[31]

| Exemption | Amount Raised | Percentage of Total |
|---|---|---|
| Rule 506(b) of Regulation D | $ 1,492 | 54.73% |
| **Rule 506(c) of Regulation D** | **$ 66** | **2.42%** |
| Rule 504 of Regulation D | $ 0.228 | 0.01% |
| Regulation D Subtotal | $ 1,558.228 | 57.15% |
| **Regulation A: Tier 1** | **$ 0.044** | **0.00%** |
| **Regulation A: Tier 2** | **$ 0.998** | **0.04%** |
| **Regulation A Subtotal** | **$ 1.042** | **0.04%** |
| Regulation Crowdfunding | $ 0.062 | 0.00% |
| Other exempt offerings | $ 1,167 | 42.80% |
| Total | $ 2,726.332 | 100.00% |
| **JOBS Act Offerings** | **$ 67.104** | **2.46%** |

[29] Jay R. Ritter, Initial Public Offerings: Updated Statistics, University of Florida, March 11, 2022 https://site.warrington.ufl.edu/ritter/files/IPO-Statistics.pdf.

[30] "Concept Release on Harmonization of Securities Offering," Securities and Exchange Commission, June 18, 2019, Table 2, p. 19 https://www.sec.gov/rules/concept/2019/33-10649.pdf.

[31] "Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets," Proposed Rule, March 4, 2020, Table 1, p. 9 https://www.sec.gov/rules/proposed/2020/33-10763.pdf.

Capital Reported Raised under Regulation A
June 19, 2015 -December 31, 2019 ($ millions)[32]

| | Tiers 1 & 2 | Tier 1 | Tier 2 |
|---|---|---|---|
| Aggregate dollar amount reported raised | $ 2,445.9 | $ 230.4 | $ 2,215.6 |
| Number of issuers reporting proceeds | 183 | 39 | 144 |
| Average dollar amount reported raised | $ 13.4 | $ 5.9 | $ 15.4 |

Among the largest reason for the relative unimportance of Tier 1 is the fact that the Commission chose to only preempt state blue sky registration and qualification requirements with respect to Tier 2. This has an obvious cure.

***The Importance of Entrepreneurial Capital Formation***

Entrepreneurship matters. It fosters discovery and innovation.[33] Entrepreneurs also engage in the creative destruction of existing technologies, economic institutions and business production or management techniques by replacing them with new and better ones.[34] Entrepreneurs bear a high degree of uncertainty and are the source of much of the dynamism in our economy.[35] New, start-up businesses account for much, if not most, of the net job creation in the economy.[36] Entrepreneurs innovate, providing consumers with new or better products. They provide other businesses with innovative, lower cost production methods and are, therefore, one of the key factors in productivity

[32] "Report to the Commission, Regulation A Lookback Study and Offering Limit Review Analysis," Securities and Exchange Commission, March 4, 2020, Table 2, p. 8 https://www.sec.gov/files/regulationa-2020.pdf.

[33] Israel M. Kirzner, *Competition and Entrepreneurship* (University of Chicago Press: 1973); Israel M. Kirzner, "Entrepreneurial Discovery and the Competitive Market Process: An Austrian Approach," *Journal of Economic Literature*, Vol. 35, No. 1 (1997); Randall Holcombe, *Entrepreneurship and Economic Progress* (Routledge: 2006); William J. Baumol, *The Microtheory of Innovative Entrepreneurship* (Princeton University Press: 2010).

[34] See, e.g., Joseph Schumpeter, *Capitalism, Socialism, and Democracy* (1942; Routledge: 1976), pp. 81-86 http://digamo.free.fr/capisoc.pdf; W. Michael Cox and Richard Alm, "Creative Destruction," *Concise Encyclopedia of Economics* (Liberty Fund: 2010) http://www.econlib.org/library/Enc/CreativeDestruction.html; Henry G. Manne, "The Entrepreneur in the Large Corporation," in *The Collected Works of Henry G. Manne*, Vol. 2 (Liberty Fund: 1996).

[35] Frank H. Knight, *Risk, Uncertainty, and Profit* (Houghton Mifflin: 1921) http://www.econlib.org/library/Knight/knRUP.html; Richard J. Cebula, Joshua C. Hall, Franklin G. Mixon Jr. and James E. Payne, *Economic Behavior, Economic Freedom, and Entrepreneurship* (Edward Elgar: 2015).

[36] Magnus Henrekson and Dan Johansson, "Gazelles as Job Creators: A Survey and Interpretation of the Evidence," *Small Business Economics*, Vol. 35 (2010), pp. 227–244 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1092938; Ryan Decker, John Haltiwanger, Ron Jarmin, and Javier Miranda, "The Role of Entrepreneurship in US Job Creation and Economic Dynamism," *Journal of Economic Perspectives*, Vol. 28, No. 3 (Summer 2014), pp. 3–24 http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.28.3.3; Salim Furth, "Research Review: Who Creates Jobs? Start-up Firms and New Businesses," Heritage Foundation Issue Brief No. 3891, April 4, 2013 http://www.heritage.org/research/reports/2013/04/who-creates-jobs-startup-firms-and-new-businesses. In terms of the neo-classical growth model, entrepreneurship is an important factor affecting the rate of technological change and the marginal productivity of capital. See, e.g., Robert M. Solow, *Growth Theory: An Exposition* (Oxford University Press: 2000). Legal institutions, human capital and other factors are also important determinants of economic growth. See N. Gregory Mankiw, David Romer and David N. Weil, "A Contribution to the Empirics of Economic Growth," *The Quarterly Journal of Economics*, Vol. 107, No. 2 (May, 1992), pp. 407-437 https://eml.berkeley.edu/~dromer/papers/MRW_QJE1992.pdf; Robert J. Barro, *Economic Growth*, 2nd edition (MIT Press: 2003).

improvement and real income growth.[37] The vast majority of economic gains from innovation and entrepreneurship accrue to the public at large rather than entrepreneurs.[38] Entrepreneurs are central to the dynamism, creativity and flexibility that enables market economies to consistently grow, adapt successfully to changing circumstances and create sustained prosperity.[39] Entrepreneurship promotes the common good, prosperity and a higher standard of living. Among the most important factors impeding entrepreneurship are securities laws that restrict entrepreneurs' access to the capital needed to launch or grow their businesses.[40] After all, without capital to launch a business, other impediments to entrepreneurial success are moot.

Sometimes, an entrepreneur has sufficient capital to launch and grow his or her business from personal savings, including profits from previous entrepreneurial ventures, and retained earnings. Often, however, an entrepreneurial firm will need capital from outside investors or lenders.[41] Other than friends or family, outside investors are typically described as "angel investors" or "venture capitalists."[42] Typically, "angel investors" are individuals who invest at the early "seed stage"

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[37] Ralph Landau, "Technology and Capital Formation," in *Technology and Capital Formation*, Dale W. Jorgenson and Ralph Landau, editors (MIT Press: 1989).

[38] Yale economist William Nordhaus has estimated that 98 percent of the economic gains from innovation and entrepreneurship are received by persons other than the innovator. See William D. Nordhaus, "Schumpeterian Profits in the American Economy: Theory and Measurement," NBER Working Paper No. 10433, April 2004 https://www.nber.org/papers/w10433.pdf.

[39] See, Decker *et al*, *supra*; C. Mirjam van Praag and Peter H. Versloot, "What is the Value of Entrepreneurship? A Review of Recent Research," *Small Business Economics*, Volume 29, Issue 4 (December 2007), pp 351-382 https://link.springer.com/content/pdf/10.1007%2Fs11187-007-9074-x.pdf; David R. Burton, "Improving Entrepreneurs' Access to Capital: Vital for Economic Growth," Heritage Foundation Backgrounder No. 3182, February 14, 2017 https://www.heritage.org/sites/default/files/2017-02/BG3182.pdf; Deirdre N. McCloskey *Bourgeois Equality: How Ideas, Not Capital or Institutions, Enriched the World* (University of Chicago Press: 2016); Adam Thierer, *Permissionless Innovation: The Continuing Case for Comprehensive Technological Freedom* (Mercatus Center: 2016); David R. Burton, "Building an Opportunity Economy: The State of Small Business and Entrepreneurship," Testimony before the Committee on Small Business, United States House of Representatives, March 4, 2015 https://www.heritage.org/testimony/building-opportunity-economy-the-state-small-business-and-entrepreneurship; George Gilder, "Capitalism is an Information and Learning System," Remarks, November 15, 2018 https://www.heritage.org/markets-and-finance/event/capitalism-information-and-learning-system; Friedrich A. Hayek, "The Use of Knowledge in Society," *The American Economic Review*, Vol. 35, No. 4 (September, 1945), pp. 519-530 https://www.econlib.org/library/Essays/hykKnw.html.

[40] Banking laws and practices are a contributing factor. For a short introduction to the problems, see SEC Commissioner Daniel M. Gallagher, "Whatever Happened to Promoting Small Business Capital Formation?," September 17, 2014 http://www.sec.gov/News/Speech/Detail/Speech/1370542976550#.VFfbI8mGklQ.

[41] See, e.g., "2013 State of Entrepreneurship Address: Financing Entrepreneurial Growth," Kauffman Foundation Research Paper, February 5, 2013 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2212743; *The Oxford Handbook of Venture Capital*, Douglas Cumming, Editor (Oxford: 2012).

[42] See Angel Capital Association http://www.angelcapitalassociation.org/ and National Venture Capital Association http://www.nvca.org/. See also Ibrahim, Darian M., "Should Angel-Backed Start-ups Reject Venture Capital?," *Michigan Journal of Private Equity & Venture Capital Law*, Vol. 2, pp. 251-269 http://scholarship.law.wm.edu/cgi/viewcontent.cgi?article=2734&context=facpubs; Abraham J.B. Cable, "Fending For Themselves: Why Securities Regulations Should Encourage Angel Groups," *University of Pennsylvania Journal of Business Law*, Vol. 13, No. 1, Fall 2010, pp. 107-172 https://www.law.upenn.edu/journals/jbl/articles/volume13/issue1/Cable13U.Pa.J.Bus.L.107%282010%29.pdf; Darian M. Ibrahim, "The (Not So) Puzzling Behavior of Angel Investors," *Vanderbilt Law Review*, Vol. 61, p. 1405-1452 (2008) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=984899; Brent Goldfarb, Gerard Hoberg, David Kirsch and Alexander Triantis, "Does Angel Participation Matter? An Analysis of Early Venture Financing," Angel Capital Association, April 4, 2008

while "venture capitalists" are firms or funds that make investments later in the firms' life-cycle after "proof of concept." Firms seeking outside investors are often the most dynamic, high growth companies.[43] In principle, Regulation A and Regulation CF would allow ordinary investors to invest in young firms and for young firms to find a new source of capital. So far, Regulation CF has been of relatively minor importance largely due to the regulatory and statutory structure of these exemptions. Regulation A, while of some importance, has been hindered by the regulatory burden it imposes as well. Regulation D and other private offerings remain, by far, the most important source of capital for young, dynamic firms. It is no accident that Regulation D is the most lightly regulated of the three.

***Legislative Analysis***

Last February, Senator Toomey issued a request for proposals that would "accelerate economic growth and spur job creation by encouraging more companies to become publicly traded, improving the market for private capital, and enhancing retail investor access to investment opportunities."[45] To that end, Senate Banking Committee Republicans this Congress have introduced a number of pieces of legislation that would advance these priorities. This section analyzes a number of these legislative items. All bill numbers refer to bills in the 117th Congress unless specifically indicated otherwise.

1. *Middle Market IPO Cost Underwriting Act (S. 3980)*

This constructive bill introduced by Sen. Lummis,[46] would instruct the SEC, in consultation with FINRA, to carry out a study of the costs associated with small IPOs and Regulation A Tier 2, including how those costs have changed over time and the impact of these costs on capital formation. There is a serious need for better information regarding the costs of becoming and remaining a public company. The SEC has been largely unwilling to collect and publish this kind of information. It is as if the agency is genuinely oblivious to the costs it imposes on issuers and the impact its rules have on the cost of capital and the vibrancy of public capital markets. This bill would help correct the Commission's irresponsible neglect of this very important issue.

Although there may be some others, I am aware of only two instances in the past quarter century where the Commission has discussed *quantitatively* the costs associated with an IPO. The SEC certainly does not make a habit of it and the information available to policymakers is extraordinarily limited.

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http://www.angelcapitalassociation.org/data/ACEF/ACEFDocuments/Does%20Angel%20Participation%20Matter%20-%20Analysis%20of%20Early%20Venture%20Financing.pdf.

[43] Sampsa Samila and Olav Sorenson, "Venture Capital, Entrepreneurship, and Economic Growth, *Review of Economics and Statistics*, February, 2011, Vol. 93, No. 1, pp. 338-349; Dane Stangler, "High-Growth Firms and the Future of the American Economy, Kauffman Foundation, March 9, 2010 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1568246.

[45] "Toomey Requests Proposals to Foster Economic Growth and Capital Formation," Press Release, February 2, 2021 https://www.toomey.senate.gov/newsroom/press-releases/toomey-requests-proposals-to-foster-economic-growth-and-capital-formation. See also, "Submissions," Committee on Banking, Housing and Urban Affairs, United States Senate https://www.banking.senate.gov/resources/data-submissions.

[46] Sens. Sinema, Warner and Hagerty are original cosponsors.

In 2013, in a proposing release for Regulation CF, the SEC referenced survey data[47] that indicated "the average cost of achieving initial regulatory compliance for an initial public offering is $2.5 million, followed by an ongoing compliance cost, once public, of $1.5 million per year."[48] In 1996, the *Report of the Advisory Committee on the Capital Formation and Regulatory Process* found that the costs associated with an initial public offering during the period 1993-1995 for those filing an S-1 was 16.4 percent of the amount raised and for those filing an SB-2[49] it was 28.9 percent of the amount raised.[50] Costs are almost certainly higher now, even in inflation adjusted terms, although the costs as a percentage of the amount of capital raised may not be because firms are going public much later in their life-cycle after they have achieved much larger size and, therefore, the offerings are larger.

The number of public companies was in steady decline. The number of listed companies declined from 8,090 in 1996 to 4,266 at the end of 2019, a decline of 47 percent.[51] The number of listed companies per million people declined from 30 in 1996 to 13 in 2019, a decline of 57 percent.[52] The number of listed companies per trillion dollars of real (inflation-adjusted) Gross Domestic Product declined from 733 to 224 or by 69 percent.[53] The precipitous decline stopped in 2012, the year that the JOBS Act was enacted. However, the number of listed companies has increased only four percent in the nine years since the JOBS Act was enacted. Thus, while there has not been a significant increase in the number of public companies in the U.S. since the JOBS Act, the decline has stopped.

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[47] "Rebuilding the IPO On-Ramp Putting Emerging Companies and the Job Market Back on the Road to Growth," IPO Task Force, Chart H, p. 10, October 20, 2011 https://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf.

[48] "Crowdfunding," Proposed Rules, *Federal Register*, Vol. 78, No. 214 (November 5, 2013), p. 66509 (col. 2), http://www.gpo.gov/fdsys/pkg/FR-2013-11-05/pdf/2013-25355.pdf.

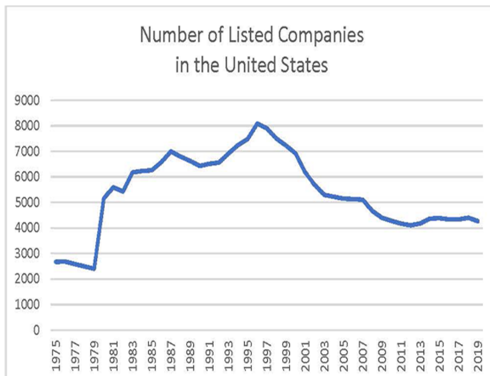
[49] In 2008, the Form SB-2 was retired in connection with the adoption of the smaller reporting company rules. See "Changeover to the SEC's New Smaller Reporting Company System by Small Business Issuers and Non-Accelerated Filer Companies: A Small Entity Compliance Guide," January 25, 2008 https://www.sec.gov/info/smallbus/secg/smrepcosysguid.pdf.

[50] *Report of the Advisory Committee on the Capital Formation and Regulatory Process*, Securities and Exchange Commission, July 24, 1996, Table 1 https://www.sec.gov/news/studies/capform/capffull.txt.

[51] Listed Domestic Companies, Total - United States, World Bank https://data.worldbank.org/indicator/CM.MKT.LDOM.NO?locations=US.

[52] "Number of Listed Companies per Million People," Federal Reserve Board of Saint Louis https://fred.stlouisfed.org/series/DDOM01USA644NWDB.

[53] Author's calculations using World Bank and Bureau of Economic Analysis, National Income and Product Accounts data. 8,090 / $11,038.3 = 733; 4,266 / $19,032.7 = 224, a decline of 69 percent. See National Income and Product Accounts Table 1.1.6. Real Gross Domestic Product, Chained Dollars [Billions of chained (2012) dollars] for NIPA data.




Source: World Bank[54]

The regulatory costs of initial public offerings and of continued regulatory compliance, once public, are a major reason for the decline in the number of public companies.[55] The heightened litigation costs and risks of being a public company are another. Yet the SEC has made no serious effort to gauge the magnitude of these costs or the impact of these costs on capital formation. That needs to change. The Middle Market IPO Cost Underwriting Act would be an important step towards making the Commission confront the impact of the costs it imposes on issuers.

2. *Dodd-Frank Material Disclosure Improvement Act (S. 3923)*

This important bill, introduced by Sen. Cramer, would repeal the conflict minerals, mine safety, resource extraction, and pay ratio provisions the Dodd- Frank Wall Street Reform and Consumer Protection Act. Specifically, it would repeal section 953 (relating to executive compensation and so-called "pay versus performance"), section 1502 (relating to conflict minerals), section 1503 (relating to coal or other mine safety), or section 1504 (relating to resource extraction). These provisions are extremely expensive for issuers to comply with and provide no material information to investors seeking to make investment decisions. They are politically motivated disclosure requirements.[65] This bill would make a substantial contribution to the effort to reducing the cost of being a public company and be an important step to reorienting securities laws toward their fundamental purpose of providing investors with information material to their investment decisions.

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[54] The data used to generate the graph is available here:
https://api.worldbank.org/v2/en/indicator/CM.MKT.LDOM.NO?downloadformat=excel
[55] David R. Burton, "Reducing the Burden on Small Public Companies Would Promote Innovation, Job Creation, and Economic Growth," Heritage Foundation Backgrounder No. 2924, June 20, 2014
https://thf_media.s3.amazonaws.com/2014/pdf/BG2924.pdf.
[65] David R. Burton, "How Dodd–Frank Mandated Disclosures Harm, Rather than Protect, Investors," Heritage Foundation Issue Brief No. 4526, March 10, 2016 http://thf-reports.s3.amazonaws.com/2016/IB4526.pdf.

*3. Reporting Requirements Reduction Act of 2022 (S. 3919)*

This bill, introduced by Sen. Tillis, would allow any issuer currently required to file quarterly reports to elect to file semi-annually. I am eager to read the comments on this bill, as I believe it starts an important discussion about the appropriate frequency of disclosures for public companies.

This bill would obviously reduce the frequency of reporting for electing issuers and therefore reduce costs. However, a well-functioning capital market requires timely information for securities to be priced properly. I am eager to read comments about whether only reporting twice annually may reduce the efficiency, liquidity and fairness of securities markets. However, Form 8-K current event reporting may be sufficient to compensate for the reduction in the frequency of periodic reporting (notably 10-Qs).

Appropriate mandatory disclosure requirements can promote capital formation, the efficient allocation of capital and the maintenance of a robust, public, and liquid secondary market for securities.[67] The reasons for this are that (1) the issuer is in the best position to accurately and cost-effectively produce information about the issuer;[68] (2) information disclosure promotes better allocation of scarce capital resources or has other positive externalities;[69] (3) the cost of

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[67] Robert A. Prentice, "The Economic Value of Securities Regulation," *Cardozo Law Review*, Vol. 28, No. 1 (2006), pp. 333–389, http://cardozolawreview.com/Joomla1.5/content/28-1/cross.website.pdf; Bernard S. Black, "The Legal and Institutional Preconditions for Strong Securities Markets," *UCLA Law Review*, Vol. 48 (2001), pp. 781–855, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=182169; and Luca Enriques and Sergio Gilotta, "Disclosure and Financial Market Regulation," Oxford Legal Studies Research Paper No. 68, 2014, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2423768.

[68] Marcel Kahan, "Securities Laws and the Social Cost of 'Inaccurate' Stock Prices," *Duke Law Journal*, Vol. 41, No. 5 (1992), pp. 977–1044, http://scholarship.law.duke.edu/dlj/vol41/iss5/1/; John C. Coffee Jr., "Market Failure and the Economic Case for a Mandatory Disclosure System," *Virginia Law Review*, Vol. 70 (1984), pp. 717–753; and Joel Seligman, "The Historical Need for a Mandatory Corporate Disclosure System," *Journal of Corporation Law*, Vol. 9, No. 1 (1983), p. 1.

[69] Jeffrey Wurgler, "Financial Markets and the Allocation of Capital," *Journal of Financial Economics*, Vol. 58, No. 187 (2000), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1972124&download=yes; R. David Mclean, Tianyu Zhang, and Mengxin Zhao, "Why Does the Law Matter? Investor Protection and its Effects on Investment, Finance, and Growth," *The Journal of Finance*, Vol. 67, No. 1 (2012), pp. 313–350; Ronald A. Dye, "Mandatory versus Voluntary Disclosures: The Cases of Financial and Real Externalities," *The Accounting Review*, Vol. 65, No. 1 (1990), pp. 1–24; Brian J. Bushee and Christian Leuz, "Economic Consequences of SEC Disclosure Regulation: Evidence from the OTC Bulletin Board," *Journal of Accounting and Economics*, Vol. 39, No. 2 (2005), pp. 233–264, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=530963; Joseph A. Franco, "Why Antifraud Provisions Are Not Enough: The Significance of Opportunism, Candor and Signaling in the Economic Case for Mandatory Securities Disclosure," *Columbia Business Law Review*, Vol. 2002, No. 2 (2002), pp. 223–362, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=338560 or http://cblr.columbia.edu/archives/10795; Paul M. Healy and Krishna G. Palepu, "Information Asymmetry, Corporate Disclosure, and The Capital Markets: A Review of the Empirical Disclosure Literature," *Journal of Accounting and Economics*, Vol. 31 (2001), pp. 405–440, http://tippieweb.iowa.uiowa.edu/accounting/mcgladrey/winterpapers/kothari1.pdf; and Anat R. Admati and Paul C. Pfleiderer, "Forcing Firms to Talk: Financial Disclosure Regulation and Externalities," *Review of Financial Studies*, Vol. 13, No. 3 (2000), pp. 479–519, https://faculty-gsb.stanford.edu/admati/documents/Forcingfirmstotalk_research.pdf.

capital may decline because investors will demand a lower risk premium;[70] (4) disclosure makes it easier for shareholders to monitor management;[71] and (5) disclosure makes fraud enforcement easier because evidentiary hurdles are more easily overcome.[72]

On the other hand, mandatory disclosure laws often impose very substantial costs. Clearly this bill is designed to reduce these costs. These costs do not increase linearly with company size. Offering costs are larger as a percentage of the amount raised for small offerings. And continuing disclosure costs are higher as a percentage of revenues or earnings for smaller firms. The costs therefore have a disproportionate adverse impact on small firms. Moreover, the benefits of mandated disclosure are also less for small firms because the number of investors and amount of capital at risk is less. Since the costs are disproportionately high and the benefits lower for smaller firms, disclosure should be scaled so that smaller firms incur lower costs.

These considerations require a balancing by policymakers of competing concerns and are, to some degree, an empirical question.[73] One thing that commenters could consider is whether it might be better to revise this bill to, as part of a scaled disclosure regime, so that only smaller reporting companies and perhaps EGCs may elect to report less frequently. If it works well, in conjunction with current event reporting on Form 8-K, Congress could revisit the issue and expand the provision to all issuers.

4. *Restoring Shareholder Transparency Act (S. 3945)*

This constructive bill, introduced by Sen. Hagerty, also would start an important discussion. It would (1) provide explicit statutory authority for the SEC to regulate proxy advisory firms, (2) stop the new SEC practice of permitting shareholder proposals that would normally have been

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[70] Christine A. Botosan, "Evidence that Greater Disclosure Lowers the Cost of Equity Capital," *Journal of Applied Corporate Finance*, Vol. 12, No. 4 (2000), pp. 60–69, and Charles P. Himmelberg, R. Glenn Hubbard, and Inessa Love, "Investor Protection, Ownership, and the Cost of Capital," World Bank Policy Research Working Paper No. 2834, 2002, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=303969.

[71] The interests of shareholders and management are often not coincident and may considerably conflict. Corporate managers often operate firms as much for their own benefit as that of shareholders, and shareholders may have difficulty preventing this in a cost-effective way. This incongruity of interest is often described as the agent-principal problem, or collective-action problem, and is significant in larger firms where ownership and management of the firm are separate, and ownership is widely held. See Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics*, Vol. 3, No. 4 (1976), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=94043; Paul G. Mahoney, "Mandatory Disclosure as a Solution to Agency Problems," *University of Chicago Law Review*, Vol. 62, No. 3 (1995), pp. 1047–1112; and Merritt B. Fox, "Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment," *Virginia Law Review*, Vol. 85, No. 7 (1999), pp. 1335–1419.

[72] Requiring certain written affirmative representations in public disclosure documents deters fraud because proving fraud becomes easier if the public, written representations are later found by a trier of fact to be inconsistent with the facts. Periodic reporting (such as 10-Ks, 10-Qs, and 8-Ks) can help police secondary-market manipulation by issuers and insiders.

[73] David R. Burton, "Securities Disclosure Reform," Chapter 5, *Prosperity Unleashed: Smarter Financial Regulation*, Norbert J. Michel, Editor (The Heritage Foundation: 2017) http://thf-reports.s3.amazonaws.com/2017/ProsperityUnleashed.pdf or David R. Burton, "Securities Disclosure Reform," Heritage Foundation Backgrounder No. 3178, February 13, 2017 https://www.heritage.org/sites/default/files/2017-02/BG3178.pdf.

excludable but now are permitted because they focus on a "significant social policy,"[74] (3) exempt all issuers from federal shareholder proposal regulations unless they opt-in[75] and (4) amend shareholder proposal regulations to require higher levels of share ownership. The bill would require shareholders seeking to make a proposal to hold one percent of the market value of the company's securities rather than various dollar amounts, the largest of which is currently $25,000 held for one year. Unlike current rules, it would impose no holding period and, also unlike current rules, the bill would allow the aggregation of two or more shareholders' holdings to meet the one percent threshold.[76]

The power wielded by the two dominant proxy advisory firms over huge segments of our economy is a problem that needs to be addressed but it needs to be addressed in a way that does not harm small shareholders. I intend to make specific recommendations on this within the next four to six weeks.

There is a balance that needs to be stuck by policymakers with respect to shareholder proposals. The principal-agent problem or collective action problem is very real. Management often acts in its own interest to the detriment of shareholders and widely dispersed share ownership makes it difficult for shareholders to monitor and police management. For that reason, policymakers do not want to make shareholder proposals so difficult that they cannot influence the Board of Directors or management of companies when that is necessary to protect shareholder value. That said, we do not want to make shareholder proposals so easy that one shareholder holding one share can year after year force votes on whether the company should support the restoration of the Bourbon monarchy in France or require all of its employees to wear tin foil hats. Securing shareholder votes on shareholder proposals involves considerable expense.

There is no doubt that there is a need to reign in politically motivated shareholder resolutions that are only tangentially related to an issuers' business. Ergo, reversing Staff Legal Bulletin No. 14L (CF) is warranted.

I am eager to read comments as to whether it is advisable to entirely exempt all issuers from federal regulatory requirements with respect to any shareholder proposal and whether that would inappropriately strengthen management vis a vis shareholders. Or would a state-based approach to shareholder proposal regulation allow for an appropriate balance between management and shareholders?

Requiring a larger securities position to make a shareholder proposal makes sense but I am also eager to read comments on whether one percent of a large corporation's market capitalization – a large amount of money – is the right level. Further, revisions to the legislation could explore whether and how shareholders can obtain information about other shareholders from the issuer, so that reaching the 1% threshold will not prove to be an insurmountable barrier to all but large RIAs

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[74] Staff Legal Bulletin No. 14L (CF), Securities and Exchange Commission, November 3, 2021 https://www.sec.gov/corpfin/staff-legal-bulletin-14l-shareholder-proposals ("Under this realigned approach, proposals that the staff previously viewed as excludable because they did not appear to raise a policy issue of significance for the company may no longer be viewed as excludable under Rule 14a-8(i)(7)")
[75] 17 CFR §240.14a–8.
[76] 17 CFR §240.14a–8(b)(1).

and investment companies. Commenters should also explore if such information cannot be obtained, revisions to this legislation should lower the threshold. Another thing that revisions could explore is whether the amount required should be scaled such that when an issue is being considered for the first time, the threshold is lower than if the same or substantially similar proposal has been voted down by shareholders previously.

5. *The Main Street Growth Act (S.3097)*

Improving the secondary markets for small capitalization firms will help investors achieve a higher return and reduce risk, improve entrepreneurs' access to capital and promote innovation, economic growth and prosperity.

There are three key steps to improving secondary markets for small firms. First, improve the regulatory environment for existing non-exchange over-the-counter (OTC) securities traded on alternative trading systems (ATSs), primarily by (a) providing the same reduced blue sky burden that large companies whose securities trade on exchanges currently enjoy, (b) re-establishing the list of marginable OTC securities and (c) removing impediments to market making caused by Regulation SHO. Second, improve the regulatory environment for secondary sales of private securities (Regulation D and other private securities), primarily by codifying the so-called section 4(a)(1-1/2) exemption and ensuring that platform traded securities are eligible for the exemption. JOBS Act 201(c) and Securities Act section 4(a)(7) and section 4(d) are attempts to address this problem. They need, however, serious improvement and simplification. Third, amend the Securities Exchange Act to establish venture exchanges.[77]

This important bill, introduced by Sen. Kennedy, would accomplish the third step by creating venture exchanges. Venture exchanges could prove to be a significant step towards promoting liquidity in the secondary market for relatively small issuers and, therefore, help investors in these companies achieve fair value for their securities when they choose to sell them. The Canadian TSX Venture Exchange and the United Kingdom's Alternative Investment Market appear to be working well but have undergone some adjustment over time. These markets appear to have had a positive economic impact in the U.K. and Canada. There are at least a dozen similar but smaller markets in various countries around the world.

I intend to make specific recommendations for how to improve this legislation within the next four to six weeks.

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[77] David R. Burton, "Legislative Proposals to Enhance Capital Formation and Reduce Regulatory Burdens: Venture Exchanges," testimony before the Capital Markets and Government Sponsored Enterprises Subcommittee, Committee on Financial Services, U.S. House of Representatives, May 13, 2015, http://www.heritage.org/research/testimony/2015/legislative-proposals-to-enhance-capital-formation-and-reduce-regulatory-burdens-venture-exchanges; Daniel M. Gallagher, "How to Reform Equity Market Structure: Eliminate "Reg NMS" and Build Venture Exchanges," Chapter 7 of *Prosperity Unleashed: Smarter Financial Regulation* (Washington, DC: Heritage Foundation, 2017), edited by Norbert J. Michel https://www.heritage.org/sites/default/files/2017-02/07_ProsperityUnleashed_Chapter07.pdf (the entire book is available at http://thf-reports.s3.amazonaws.com/2017/ProsperityUnleashed.pdf); SEC Commissioner Luis A. Aguilar, "The Need for Greater Secondary Market Liquidity for Small Businesses," March 4, 2015 http://www.sec.gov/news/statement/need-for-greater-secondary-market-liquidity-for-small-businesses.html.

*6. Expanding American Entrepreneurship Act (S. 3976)*

This constructive bill, introduced by Sen. Moran, would amend the Investment Company Act such that qualifying venture capital funds could have aggregate capital contributions of $50 million rather than $10 million and increase the number of permitted beneficial owners from 250 to 500. It can be expected to increase the amount of capital available to entrepreneurs and to reduce the costs of providing them with capital. It will, therefore, have a positive economic impact.

*7. Developing and Empowering our Aspiring Leaders Act of 2022 (S.3914)*

This constructive bill, introduced by Sen. Rounds, would direct the Commission to amend its venture capital fund regulations[81] to allow secondary market acquisitions of qualifying portfolio companies, provide that investment in another venture capital fund is a qualifying investment, and make various conforming changes. This bill should have a positive impact on the ability of small firms to raise capital because, among other things, it should improve the secondary market for such securities which makes primary offerings more attractive.

*8. Small Entrepreneurs' Empowerment and Development (SEED) Act of 2022 (S.3939)*

This important bill, introduced by Sen. Scott,[82] is needed legislation. It would relieve the smallest businesses from having to worry about the complexity of the securities laws. It is simple, straight-forward and does the job. Specifically, the bill would exempt from registration requirements any issuer that sells less than $500,000 in securities of any type within a 12-month period and treat those securities as 'covered securities" thereby protecting against onerous state blue sky laws. It would make the exemption unavailable to certain designated bad actors. I have long been a strong proponent of this kind of exemption.[83]

Every business in the country should not be roped into dealing the securities laws and the SEC or the state equivalent. Some businesses are private enough, closely held enough and small enough that, absent fraud, the SEC or state securities regulators simply should not be involved. That is the point of this exemption. Any such exemption should contain bright lines that non-specialists can read and be sure that these businesses are okay. S. 3939 meets that test.

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[81] 17 CFR § 275.203(l)-1.

[82] Sen. Moran is an original cosponsor.

[83] David R. Burton, "Improving Entrepreneurs' Access to Capital: Vital for Economic Growth," Heritage Foundation Backgrounder No. 3182, February 14, 2017, p. 7 https://www.heritage.org/sites/default/files/2017-02/BG3182.pdf; David Burton, "Starting a Small Business Could Break This Federal Law," *Daily Signal*, March 24, 2016 https://www.dailysignal.com/2016/03/24/how-starting-a-small-company-could-break-this-federal-law/; section II.G.1 of the SEC "Concept Release on Harmonization of Securities Offering Exemptions," *Federal Register*, Vol. 84, No. 123, June 26, 2019, pp. 30460-30522 https://www.govinfo.gov/content/pkg/FR-2019-06-26/pdf/2019-13255.pdf; Comment Letter of David R. Burton regarding Concept Release on Harmonization of Securities Offering Exemptions, Micro-Offering Exemption, pp. 50-54 https://www.sec.gov/comments/s7-08-19/s70819-6193328-192495.pdf. See also, SEC Commissioner Daniel M. Gallagher, "Whatever Happened to Promoting Small Business Capital Formation?," September 17, 2014 https://www.sec.gov/news/speech/2014-spch091714dmg.

*9. Unlocking Capital for Small Businesses Act (S.3922)*

This important bill, introduced by Sen. Cramer, would help a great many small businesses that operate outside of affluent major metropolitan areas to find capital with the aid of finders and private placement brokers. It is important, well-drafted legislation that addresses a major problem that is under-appreciated in Washington. It would help the smallest entrepreneurs access capital found in money centers. It is hard to estimate the number of businesses that would be helped by this legislation but it will probably be in the many tens of thousands annually and potentially over a hundred thousand each year once it has been law for a reasonable period. The bill would reverse two decades of irresponsible policies pursued by the SEC.[84]

A "finder" is a person who is paid to assist small businesses to find capital from time to time by making introductions to investors. Usually, finders operate in the context of some other business (e.g., the practice of law, public accounting, insurance brokerage, etc.), as a Main Street[85] business colleague or acquaintance, or as a friend or family member of the business owner. They are sometimes called private placement brokers,[86] although this term is probably best used to describe people that are in the business of making introductions between investors and businesses. They are typically paid a small percentage of the amount of capital that they helped the business owner to raise.

Finders play an important role in introducing entrepreneurs to potential investors, thus helping them to raise the capital necessary to launch or grow their businesses. For regulatory purposes, neither finders nor private placement brokers should be treated the same as Wall Street investment banks (i.e., a large, registered broker-dealer). A business owner should be able to compensate people for helping him or her to find and raise capital. He should be able to offer, for example, a 2 percent finders' fee to those that help him identify investors. In the real world, people respond to incentives, and being able to offer a financial reward will make people more willing to take the time and effort necessary to help small business owners find the capital that they need.

In large metropolitan areas like New York, Washington, or San Francisco, there are many accredited investors and most entrepreneurs in those cities will know many accredited investors. There are also large informal networks of such investors. In the Midwest, South and Rocky Mountain West (with the exception of a few large cities) and in less developed rural areas throughout the country, accredited investors are few and far between. Most entrepreneurs in these

[84] David R. Burton, "Let Entrepreneurs Raise Capital Using Finders and Private Placement Brokers," Heritage Foundation Backgrounder No. 3328, July 10, 2018 https://www.heritage.org/sites/default/files/2018-07/BG3328.pdf; American Bar Association, "Report and Recommendations of the Task Force on Private Placement Broker–Dealers," June 20, 2005, http://www.sec.gov/info/smallbus/2009gbforum/abareport062005.pdf; Gregory C. Yadley, "Notable by their Absence: Finders and Other Financial Intermediaries in Small Business Capital Formation," presentation to the Advisory Committee on Small and Emerging Businesses, U.S. Securities and Exchange Commission, June 3, 2015, http://www.sec.gov/info/smallbus/acsec/finders-and-other-financial-intermediaries-yadley.pdf.

[85] By Main Street business, I mean a privately held, non-financial business.

[86] Particularly by those familiar with the work and proposals of the American Bar Association Task Force on Private Placement Broker-Dealers. American Bar Association, "Report and Recommendations of the Task Force on Private Placement Broker–Dealers," June 20, 2005, http://www.sec.gov/info/smallbus/2009gbforum/abareport062005.pdf.

regions will only know a few accredited investors and informal investor networks do not exist or are very small. Finders represent an opportunity to enable entrepreneurs in these regions to find accredited investors from outside of their communities.

The map below illustrates this problem by mapping median household income.[87] The differences between the high-income areas designated by dark blue and low-income areas designated by yellow are differences of 65 percent or more. High incomes are very geographically concentrated on the coasts, a few other large cities and areas where the oil and gas industry is active. These later areas disappear from the map once the income threshold is lifted by about $25,000-$35,000 since even well-paying blue collar jobs do not generate household incomes over $100,000 in most parts of the country. Previous Census Bureau maps that used higher thresholds for their top bracket reflect this.

If the percentage of the population that qualified as an accredited investor were mapped by county, the differences would be even more dramatic. Even many of the places marked dark blue on this map (median household income >$65,000) will have a vanishingly small percentage of the population that have incomes high enough to qualify as accredited ($200,000 single, $300,000 joint). The Division of Economic and Risk Analysis (DERA) should obtain data from the Census Bureau (the American Community Survey and other data) or the Internal Revenue Service Statistics of Income public use file and map accredited investor data by state and county. Because, however, in many small or rural counties there are so few accredited investors, some county data may be masked. Thus, DERA may have to use core-based statistical areas[88] or metropolitan statistical areas to generate the map instead of county data.[89]

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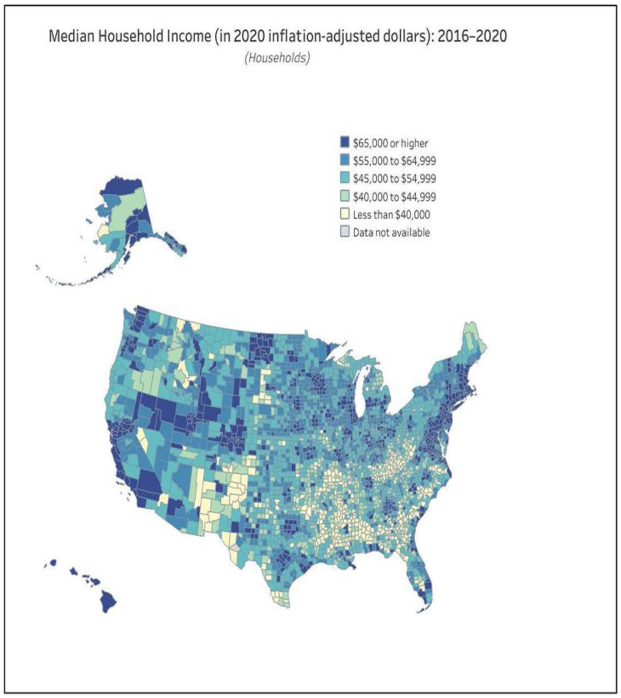
[87] "What Can You Learn About Counties From the American Community Survey?," Median Household Income (in 2020 inflation-adjusted dollars): 2016–2020 (Households), Census Bureau https://www.census.gov/library/visualizations/interactive/acs-counties-2016-2020.html.
[88] One or more adjacent counties or county equivalents that have at least one urban core area of at least 10,000 population. There are nearly 1,000 CBSAs.
[89] One or more adjacent counties or county equivalents that have at least one urban core area of at least 50,000 population, plus adjacent territory that has a high degree of social and economic integration with the core as measured by commuting ties. There are nearly 400 MSAs.




Source: Census Bureau

The current legal status of finders is a morass. It is a morass created by the Commission. It withdrew the guidance governing finders, various officials gave a series of speeches indicating that finders were probably unregistered broker-dealers, no addition guidance or rulemaking was forthcoming and selective regulation by enforcement was undertaken. The Commission articulated the view that even those tangentially involved in a transaction were finders, especially if they took "transaction-based compensation" or, in other words, if they took compensation for actually doing what they said they would do. This is not only bad public policy but significantly beyond the scope of the statutory definition of a broker, to wit, "any person engaged in the business of effecting transactions in securities for the account of others."[90]

After two decades of procrastination and neglect by the Commission and its staff, the Commission last Autumn proposed an exemptive order[91] that would improve the existing situation. The

[90] Securities Exchange Act, § 3(a)(4).
[91] Notice of Proposed Exemptive Order Granting Conditional Exemption From the Broker Registration Requirements of Section 15(a) of the Securities Exchange Act of 1934 for Certain Activities of Finders," Notice of

proposed exemptive order is, however, markedly too narrow regarding the proposed Tier I finders category and should be improved.[92] Its fate at the Commission is now very much in doubt. Entrepreneurs cannot afford to wait another two decades for this problem to be favorably resolved by the Commission. Congress should Act.

*10. Small Business Mergers, Acquisitions, Sales, and Brokerage Simplification Act of 2021 (S.3391)*

This constructive bill, introduced by Sen. Kennedy, would substantially mitigate a long-standing problem. It would exempt certain M&A Brokers from the requirement to register as a broker-dealer subject to limitations on their activities.

Business brokers make the market for closely held small businesses more efficient, by helping entrepreneurs to sell their business for full value and by helping aspiring business owners find business opportunities that match their skills and financial resources.[93] Although, after many years of delay, the Securities and Exchange Commission issued in 2014 a no-action letter that improves the situation,[94] its position on who should be required to register as a securities broker-dealer remains overbroad and significantly exceeds the scope of the statutory requirement. Complying with the requirements of the no-action letter is far from simple.

The preferred solution is for business brokers helping to buy and sell small businesses to simply be exempt from the broker-dealer registration requirements. This bill is a major step in that direction. In 2017, the House unanimously passed the "Small Business Mergers, Acquisitions, Sales, and Brokerage Simplification Act."[95] The Senate has failed to do so.

*11. Gig Worker Equity Compensation Act (S.3931)*

This constructive bill, introduced by Sen. Lummis, would extend Rule 701 provisions relating to compensatory benefit plans to "individuals (other than employees) providing goods for sale, labor, or services for remuneration to an issuer, or to customers of an issuer, to the same extent as that exemption applies to employees of the issuer."

Allowing independent contractors or "gig workers" to share in the financial success of the issuer that they work for and allowing the issuer to align their incentives with those of the issuer by

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Proposed Exemptive Order; Request for Comments, *Federal Register*, Vol. 85, No. 198, October 13, 2020, pp. 64542-64551 (Release No. 34-90112) https://www.govinfo.gov/content/pkg/FR-2020-10-13/pdf/2020-22565.pdf .

[92] Comment Letter of David R. Burton regarding the Proposed Exemptive Order for Certain Activities of Finders November 12, 2020 https://www.sec.gov/comments/s7-13-20/s71320-8011714-225387.pdf.

[93] David R. Burton, "Don't Overregulate Business Brokers," Heritage Foundation Backgrounder No. 2883, February 19, 2014 https://thf_media.s3.amazonaws.com/2014/pdf/BG2883.pdf.

[94] M & A Broker No Action Letter, January 31, 2014 [Revised: February 4, 2014] https://www.sec.gov/divisions/marketreg/mr-noaction/2014/ma-brokers-013114.pdf.

[95] See H.R.609, 116th Congress, "The Small Business Mergers, Acquisitions, Sales, and Brokerage Simplification Act" (Rep. Huizenga). On December 7, 2017, this bill passed the House by a vote of 426-0. It has yet to be enacted into law. See also section 401 of H.R.10, 115th Congress, the Financial CHOICE Act of 2017, passed by the House.

providing securities to the workers is laudable and deserves support. I will provide some suggestions regarding potential improvements in the next few weeks.

*12. Increasing Investor Opportunities Act (S.3948)*

This constructive bill could potentially have a significant positive impact on non-accredited investor returns by giving them access to professionally managed funds that invest in private offerings.

*13. Improving Crowdfunding Opportunities Act (S.3967)*

This constructive bill, introduced by Sen. Moran, would make significant improvements to crowdfunding, particularly the regulation of funding portals. It would broaden blue sky preemption, reverse a badly conceived SEC interpretation of its Regulation CF that treats crowdfunding portals as issuers for liability purposes, limits the Bank Secrecy Act requirements for funding portal requirements since funding portals are prohibited from holding customer funds by law and the investor funds held by banks are fully subject to AML-CFT Bank Secrecy Act requirements, and explicitly permit impersonal investment advice that does not purport to meet the objectives or needs of a specific individual or account. All of these are very helpful and will improve the attractiveness of crowdfunding. Given, however, the complexity and burden that Congress and then the SEC added to Title III, Congress should also consider whether more fundamental reforms will be necessary for equity crowdfunding to fulfill its promise.[98]

*14. Equal Opportunity for all Investors Act (S.3921)*

Regulation D investments are generally restricted to accredited investors, who are affluent individuals or institutions. The vast majority of Americans are effectively prohibited from investing in Regulation D securities. The SEC currently estimates that only about 16 million households (13 percent of the total) qualify as accredited.[99] Companies are going public much later than in the past, so those who invest in private offerings generally receive a higher share of returns generated by successful entrepreneurial ventures than those who invest in relatively late-stage public companies. Congress should democratize access to these private offerings so that they are available to more investors.[100]

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[98] See discussion above under the JOBS Act heading and David R. Burton, "Improving Entrepreneurs' Access to Capital: Vital for Economic Growth," Heritage Foundation Backgrounder No. 3182, February 14, 2017 https://www.heritage.org/sites/default/files/2017-02/BG3182.pdf; Thaya Brook Knight, "A Walk Through the JOBS Act of 2012: Deregulation in the Wake of Financial Crisis," Cato Institute Policy Analysis 790, May 3, 2016 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2833877#; Comment letter of David R. Burton regarding Crowdfunding, February 3, 2014 http://www.sec.gov/comments/s7-09-13/s70913-192.pdf; Comment letter of Rutheford B Campbell, Jr., regarding Crowdfunding, February 14, 2014 http://www.sec.gov/comments/s7-09-13/s70913-278.pdf; Comment Letter of David R. Burton regarding Concept Release on Harmonization of Securities Offering Exemptions, Micro-Offering Exemption, pp. 50-54 https://www.sec.gov/comments/s7-08-19/s70819-6193328-192495.pdf.

[99] SEC "Concept Release on Harmonization of Securities Offering Exemptions," *Federal Register*, Vol. 84, No. 123, June 26, 2019, Table 3 — Households Qualifying Under Existing Accredited Investor Criteria, p. 30471.

[100] David R. Burton, "Congress Should Increase Access to Private Securities Offerings," Heritage Foundation Issue Brief No. 4899, August 29, 2018 https://www.heritage.org/sites/default/files/2018-08/IB4899.pdf; Thaya Brook Knight, "Your Money's No Good Here: How Restrictions on Private Securities Offerings Harm Investors," Cato

This important bill, introduced by Sen. Tillis,[101] would substantially democratize access to Regulation D private placements. It would allow people to test into accredited investor status by demonstrating their knowledge of investing. It would generally permit self-certification by investors as to whether they meet income or net worth requirements in all Rule 506 offerings. This is a particular step forward for Rule 506(c) offerings. Any natural person with at least $500,000 worth of investments would qualify. Any person investing no more than (a) 10 percent of the total investments of the person; (b) 10 percent of the annual income of the person or 10 percent of the annual combined income with that person's spouse; or (c) 10 percent of the net worth of the person excluding the value of the person's principal place of residence in private offerings would qualify. It would give millions of people access to Regulation D private offerings that are currently generally barred from investing in those offerings. Additional professional certification or educational attainment criteria could be added.

The final rule implementing Title II of the JOBS Act[102] created a safe harbor that inevitably, in practice, became the rule. Thus, "reasonable steps to verify" requirement for what became Rule 506(c) effectively means obtaining tax returns or comprehensive financial data proving net worth. Many investors are reluctant to provide such sensitive information to issuers with whom they have no relationship as the price of making an investment and, given the potential liability, accountants, lawyers and broker-dealers are unlikely to make certifications except perhaps for very large, lucrative clients. Issuers seek to avoid the compliance costs and regulatory risks.

Self-certification is the general, accepted practice for what is now known as Rule 506(b) offerings. That has been the case since the advent of Regulation D. Self-certification should be allowed for all Rule 506 offerings and obtaining an investor self-certification should be deemed to constitute taking "reasonable steps to verify that purchasers of the securities are accredited investors" as required by the JOBS Act. This is what the Equal Opportunity for all Investors Act.

Self-certification is permitted in the United Kingdom both for sophisticated investors and high net worth investors (income of £100,000 or more or net assets of £250,000 or more).[103] Neither in the

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Institute Policy Analysis No. 833, February 9, 2018 https://www.cato.org/sites/cato.org/files/pubs/pdf/pa833.pdf; David R. Burton, "Broadening Regulation D: Congress Should Let More People Invest in Private, High-Growth Companies," Heritage Foundation Backgrounder No. 3137. August 15, 2016 http://thf-reports.s3.amazonaws.com/2016/BG3137.pdf.

[101] Sen. Scott is an original cosponsor.

[102] Specifically, section 201(a)(1) of the Act.

[103] See *Conduct of Business Sourcebook*, United Kingdom Financial Conduct Authority, sections 4.12.6-4.12.11, https://www.handbook.fca.org.uk/handbook/COBS/4/12.html. A self-certified sophisticated investor is an individual who has signed, within the period of twelve months ending with the day on which the communication is made, a statement in the following terms:

"SELF-CERTIFIED SOPHISTICATED INVESTOR STATEMENT

I declare that I am a self-certified sophisticated investor for the purposes of the restriction on promotion of non-mainstream pooled investments. I understand that this means:

> (i) I can receive promotional communications made by a person who is authorised by the Financial Conduct Authority which relate to investment activity in non-mainstream pooled investments;

U.K. nor in 506(b) offerings (before and after the JOBS Act) has self-certification caused significant problems. The current 506(c) rules are a solution addressing a non-existent problem.

*15. Facilitating Main Street Offerings Act (S.3966)*

About $1 billion dollars annually is now raised using Regulation A.[104] It could and should be much more important.[105] One of the biggest things impeding the use of Regulation A is the fact that state blue sky laws are, under the Commission's implementing rule, preempted only with respect to Tier 2 primary offerings. All Tier 1 and Tier 2 secondary offerings are still subject to blue sky laws. NASAA's coordinated review program is an unmitigated failure and should be acknowledged as such.

This important bill, introduced by Sen. Moran, is meant to preempt blue sky laws for primary and secondary market for Regulation A Tier 2 securities. This would enable robust secondary markets in Regulation A securities to develop that would make Regulation A securities more liquid and enable investors to achieve better value when they sell their securities. It would also make primary offerings easier because investors buying from the issuer will know that they will be more easily able to sell their securities when they wish to do so.

I intend to make specific recommendations for improving the statutory text of this legislation, to ensure that it best meets its intended purpose – within the next four to six weeks.

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> (ii) the investments to which the promotions will relate may expose me to a significant risk of losing all of the property invested.

I am a self-certified sophisticated investor because at least one of the following applies:

> (a) I am a member of a network or syndicate of business angels and have been so for at least the last six months prior to the date below;
> (b) I have made more than one investment in an unlisted company in the two years prior to the date below;
> (c) I am working, or have worked in the two years prior to the date below, in a professional capacity in the private equity sector, or in the provision of finance for small and medium enterprises;
> (d) I am currently, or have been in the two years prior to the date below, a director of a company with an annual turnover of at least £1 million.

I accept that the investments to which the promotions will relate may expose me to a significant risk of losing all of the money or other property invested. I am aware that it is open to me seek advice from someone who specialises in advising on non-mainstream pooled investments.

[104] "Facilitating Capital Formation and Expanding Investment Opportunities by Improving," Proposed Rule, March 4, 2020, Table 1: Overview of amounts raised in the exempt market in 2019, p. 9.

[105] David R. Burton, "Improving Entrepreneurs' Access to Capital: Vital for Economic Growth," Heritage Foundation Backgrounder No. 3182, February 14, 2017 https://www.heritage.org/sites/default/files/2017-02/BG3182.pdf; Comment Letter of David R. Burton regarding Concept Release on Harmonization of Securities Offering Exemptions, Micro-Offering Exemption, pp. 50-54 https://www.sec.gov/comments/s7-08-19/s70819-6193328-192495.pdf; Comment Letter of David R. Burton regarding Proposed Rule "Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets," June 1, 2020 https://www.sec.gov/comments/s7-05-20/s70520-7261535-217655.pdf.

***Additional Steps to Improve Access to Capital for Entrepreneurs***

The legislation discussed in the previous section would constitute a genuinely major step forward. There are, however, a number of important reforms not addressed by these bills. The Emerging Growth Company Extension Act is expected to become a part of the JOBS Act 4.0.

*Emerging Growth Company Extension Act*

As discussed above, Title I of the JOBS Act created the Emerging Growth Company (EGC) status to reduce the cost of initial public offerings and of early continuing compliance costs. This aspect of the JOBS Act appears to have been a success. The number of IPOs has been trending upwards and roughly four-fifths of issuers conducting IPOs appear to be taking advantage of EGC status.[106] The number of IPOs in the nine years after the JOBS Act has increased by 43 percent relative to the nine years before the JOBS Act and the amount raised has increased by 57 percent.[107]

IPOs Before and After the JOBS Act

| Year | Number of IPOs | Aggregate Proceeds ($ billions) |
|---|---|---|
| 2004 | 173 | $31 |
| 2005 | 159 | $28 |
| 2006 | 157 | $30 |
| 2007 | 159 | $36 |
| 2008 | 21 | $23 |
| 2009 | 41 | $13 |
| 2010 | 91 | $30 |
| 2011 | 81 | $27 |
| 2012 | 93 | $31 |
| 2013 | 158 | $42 |
| 2014 | 206 | $42 |
| 2015 | 118 | $22 |
| 2016 | 75 | $13 |
| 2017 | 106 | $23 |
| 2018 | 134 | $33 |
| 2019 | 112 | $39 |
| 2020 | 165 | $62 |
| 2021 | 311 | $119 |
| 2004-2012 (Average) | 108 | $28 |
| 2013-2021 (Average) | 154 | $44 |

Data Source: Jay R. Ritter, Initial Public Offerings: Updated Statistics, University of Florida

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106 "Update on Emerging Growth Companies and the JOBS Act," PwC Deals, April 2018, Table: Total IPOs filed as EGCs in the United States, p. 7 https://www.pwc.com/us/en/deals/assets/pwc-deals-update-on-the-JOBS-act.pdf.

107 Jay R. Ritter, Initial Public Offerings: Updated Statistics, University of Florida, March 11, 2022 https://site.warrington.ufl.edu/ritter/files/IPO-Statistics.pdf.

Nevertheless, the number of IPOs is still *dramatically* fewer than in the 1990s and the amounts raised, particularly when adjusted for inflation, are not impressive.[108] IPOs are barely keeping pace with exits (either through mergers or delisting due to financial failure or going private transactions).[109]

The EGC provisions of JOBS Act 4.0 would extend the period that a company could retain its Emerging Growth Company status from five to ten years. This would reduce the cost of being a public company until substantial size is achieved and will, therefore, make IPOs more attractive. It is part of a well-conceived scaled disclosure regime.

The ever-increasing regulatory burden on public companies means that companies are going public much later in their life cycle. This, in turn, means that a disproportionate share of the gains from successful entrepreneurial ventures accrues to accredited investors buying private placements rather than ordinary investors who own publicly traded shares.[110] Policymakers should seek to reduce the burden on public companies so that ordinary American investors can share in these gains.

I have two suggestions about how to improve this very constructive section of the bill. First, I would suggest that EGC status be made indefinite rather than limiting it to 10 years. Second, I would recommend amending the Securities Act and the Securities Exchange Act so that EGCs (and smaller reporting companies) are exempt from (1) climate change or greenhouse gas emissions reporting,[111] (2) diversity, equity and inclusion reporting[112] and (3) human capital management reporting.[113] Of course, it would be preferable to simply define materiality so that such reporting is not required of any issuer.

The proposed climate change rule alone has been estimated by the SEC to increase the costs of being a public company by an astounding 165 percent, by $6,378,073,242 in the aggregate from $3,856,958,756 to $10,235,031,998.[114] And this is a massive underestimate because huge swaths of the costs imposed by scope 3 are not counted. In other words, the proposed climate change rule will nearly triple the costs of being a public company. With one regulation, the Commission is considering adding more costs on issuers than all of the regulations promulgated in the previous

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[108] Ibid.

[109] Listed Domestic Companies, Total - United States, World Bank https://data.worldbank.org/indicator/CM.MKT.LDOM.NO?locations=US. The number of listed companies has been essentially flat since 2012, increasing by less than ½ of one percent annually.

[110] For an analysis of the higher returns of private equity see, for example, Jeroen Cornel and Kyle McDermott, "On the Historical Outperformance of Private Equity," BlackRock Private Equity Partners, July 2021 https://www.blackrock.com/institutions/en-us/literature/whitepaper/historical-outperformance-of-private-equity.pdf.

[111] "The Enhancement and Standardization of Climate-Related Disclosures for Investors," Proposed Rule, Securities and Exchange Commission March 21, 2022 https://www.sec.gov/rules/proposed/2022/33-11042.pdf.

[112] See, for example, Corporate Board Diversity [RIN: 3235-AL91], Fall 2021 Unified Agenda of Regulatory and Deregulatory Actions, Securities and Exchange Commission https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202110&RIN=3235-AL91.

[113] Human Capital Management Disclosure [RIN: 3235-AM88], Fall 2021 Unified Agenda of Regulatory and Deregulatory Actions, Securities and Exchange Commission https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202110&RIN=3235-AM88.

[114] "The Enhancement and Standardization of Climate-Related Disclosures for Investors," Proposed Rule, Securities and Exchange Commission March 21, 2022, pp. 455-456 https://www.sec.gov/rules/proposed/2022/33-11042.pdf.

nine decades. It is difficult to conceive of a more destructive policy and, if promulgated, it will dwarf the positive impact of this legislation. The DEI and human capital management reporting requirements will just make the problem worse.

*Small Business Audit Correction Act*

The number of broker-dealers has declined by about 30 percent over the past 15 years. A large reason for this decline is the ever-increasing regulatory burden that crushes the profitability of small broker-dealers. Regulatory costs do not increase linearly with size, so heavy regulation accords a competitive advantage to large firms. The decline in small broker-dealers harms small entrepreneurs because small broker-dealers are more likely to assist them to raise capital than large investment banks.

This constructive bill[115] would exempt privately-held, non-custodial broker-dealers from the requirements to use a Public Company Accounting Oversight Board (PCAOB) registered firm for their audits. These small firms are not public companies and do not generally hold customer securities or funds. They pose no risk to the financial system as a whole. It is appropriate to allow them to comply only with normal audits rather than the more expensive PCAOB compliant audits. They would still be subject to the full panoply of both SEC and FINRA rules governing broker-dealers.[88]

*Additional Proposals Relating to Entrepreneurial Capital Formation*

See my submission to the Committee for details regarding the proposals in this section, including an analysis of why they are desirable and, in many cases, proposed statutory language.[116]

Proposals Relating to Substantive Changes to the Securities Laws

1. Congress should codify and broaden the exemption from the section 12(g) holder-of-record limitations for Regulation A securities.

2. Congress should eliminate the income and net worth limitations imposed by Regulation A (although not by Securities Act section 3(b)).

3. Congress should exempt P2P lending from federal and state securities laws.

4. Congress should amend Title III of the JOBS Act to create a category of crowdfunding security called a "crowdfunding debt security" or "peer-to-peer debt security" with lesser continuing reporting obligations.

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[115] S.2724, 116th Congress (Sen. Cotton).

[116] David R. Burton and Norbert J. Michel, Proposals to Foster Economic Growth and Capital Formation, March 18th, 2021 https://www.banking.senate.gov/imo/media/doc/David%20Burton%20and%20Norbert%20Michel%20-%202021-3-18.pdf. Note: Dr. Michel authored the proposed banking reforms.

5. Congress should statutorily define materiality in terms generally consonant with Supreme Court holdings on the issue but should specifically excludes social and political objectives unrelated to investors' financial, economic or pecuniary objectives.

6. Congress should amend the Securities Act and the Securities Exchange Act to reflect the principles of the Civil Rights Act by prohibiting securities regulators, including SROs, from promulgating rules or taking other actions that discriminate on the basis of race, color, religion, sex, or national origin of such individual or group. Legal discrimination or quotas on the basis of race or sex should be a relic of the past.

7. Congress should terminate the Consolidated Audit Trail program

Proposals Relating to Studies or Data Improvement

1. Congress should require the Division of Economic and Risk Analysis at the SEC to conduct a study mapping and reporting accredited investor data by state and county but permitting the use of core-based statistical areas or metropolitan statistical areas if data masking by the Census Bureau or the IRS Statistics of Income effectively requires their use.

2. Congress should require the SEC to publish better data on securities offerings, securities markets and securities law enforcement and to publish an annual data book of time series data on these matters (as outlined below). The Division of Economic and Risk Analysis (DERA) should publish annual data on:

(1) the number of offerings and offering amounts by type (including type of issuer , type of security and exemption used );
(2) ongoing and offering compliance costs by size and type of firm and by exemption used or registered status (e.g. emerging growth company, smaller reporting company, fully reporting company) including both offering costs and the cost of ongoing compliance;
(3) enforcement (by the SEC, state regulators and SROs), including the type and number of violations, the type and number of violators and the amount of money involved;
(4) basic market statistics such as market capitalization by type of issuer and type of security; the number of reporting companies, Regulation A issuers, crowdfunding issuers and the like; trading volumes by exchange or ATS; and
(5) market participants, including the number and, if relevant, size of broker-dealers, registered representatives, exchanges, alternative trading systems, investment companies, registered investment advisors and other information.

This data should be presented in time series over multiple years (including prior years to the extent possible) so that trends can be determined.

3. Congress should require an annual SEC and one-time GAO study that collects and reports data from state regulators on the fees or taxes they collect from issuers. These studies should collect data from at least the years 2017-2020 and classify the fees and taxes collected from issuers by offering type.

4. Congress should require an SEC study reporting the annual costs relating to Sarbanes-Oxley internal control reporting and the amounts paid by issuers each year to accounting firms in connection with compliance.

***Fundamental Reforms to Securities Law***

Ideally, Congress and the Commission would be willing to fundamentally rethink the regulation of small company capital formation. The complex, hodge-podge matrix of exemptions and disclosure requirements that has developed over the past nine decades needs to be rethought. A coherent, scaled, simplified disclosure regime with a limited number of exemptions should be developed and implemented by Congress and the Commission. It should govern both initial and continuing disclosure and be integrated across the various exemptions and categories of reporting company such that larger firms with more investors and more capital at risk have greater disclosure obligations. Policymakers should consider the cost of compliance, the investor protection benefits of the added disclosure, the cost to investors of being denied investment opportunities by investment restrictions and the cost to the public of lost economic growth, capital formation, innovation, and job creation caused by the regulation of issuers. Such an approach offers the potential to substantially improve the environment for entrepreneurial capital formation and to improve investor understanding of the capital markets primarily at the expense of attorneys, compliance advisors and, to a lesser extent, accountants who live off the complexity of the current system.

There are effectively at least 13 categories of firms issuing securities. They are:

(1) private companies using section 4(a)(2);
(2)-(5) private companies using Regulation D (Rule 504 and Rule 506 (with and without non-accredited investors);[117]
(6)-(7) small issuer Regulation A companies (two tiers);
(8)-(10) crowdfunding companies (three tiers);
(11) smaller reporting companies;
(12) emerging growth companies; and
(13) fully reporting public companies.

Each of these categories has different initial and continuing disclosure obligations, different classes of investors that can invest in the offering, different offering caps, different maximum investment restrictions and a host of other differences. The existing disclosure regime is not coherent in that in many cases smaller firms have greater disclosure requirements and the degree and type of disclosure differs significantly by the type of offering even for firms that are otherwise comparable in all meaningful respects.

[117] Rule 502(b) imposes significantly greater disclosure requirement on issuers that sell to non-accredited investors in a Rule 506(b) offering. The rules governing 506(c) offerings have a different set of rules but those differences do not primarily affect verification of accredited investor status and bad actor disqualification rather than disclosure requirements.

It is worth considering a simplified set of exemptions.[118] One possibility would be to establish three categories as follows:

A Proposal for a Reformed Exemption and Disclosure Regime

| Type of Issuer | Type of Solicitation | | Size (Public Float/ Number of Beneficial Owners or Holders of Record) | | Secondary Market Status |
|---|---|---|---|---|---|
| Private | Private | and | Below specified threshold A | and | Neither National Securities Exchange nor Venture Exchange[119] traded (but some organized secondary market permitted). |
| Quasi-Public ("Venture Firms") | General | or | Above specified threshold A | and | Both Venture Exchange and ATS trading permitted. National Securities Exchange traded. |
| Public (Registered) | General | and | Above specified threshold B | or | Both National Securities Exchange and ATS traded. |

In such a regime, private companies would have no legally mandated disclosure requirements. Disclosure requirements would be negotiated by the private parties involved much as they usually are now. The private exemption here is effectively the same as Rule 506(b) or section 4(a)(2) offerings.[120] A company would be deemed private if it did not engage in general solicitation, was below some specified number of beneficial owners,[121] holders of record or, perhaps, some measure

[118] David R. Burton, "Securities Disclosure Reform," Chapter 5, *Prosperity Unleashed: Smarter Financial Regulation*, Norbert J. Michel, Editor (The Heritage Foundation: 2017) http://thf-reports.s3.amazonaws.com/2017/ProsperityUnleashed.pdf or David R. Burton, "Securities Disclosure Reform," Heritage Foundation Backgrounder No. 3178, February 13, 2017 https://www.heritage.org/sites/default/files/2017-02/BG3178.pdf.

[119] A "Venture Exchange" is conceived of here as an exchange that is regulated in a fashion more appropriate for an exchange populated by small capitalization issuers (Regulation NMS requirements would be relaxed, market makers would be allowed and other changes). See, for example, David R. Burton, "Legislative Proposals to Enhance Capital Formation and Reduce Regulatory Burdens: Venture Exchanges," Testimony before the Capital Markets and Government Sponsored Enterprises Subcommittee of the Committee on Financial Services before the United States House of Representatives on May 13, 2015 https://www.heritage.org/testimony/legislative-proposals-enhance-capital-formation-and-reduce-regulatory-burdens-venture . See also, Daniel M. Gallagher, "How to Reform Equity Market Structure: Eliminate "Reg NMS" and Build Venture Exchanges" Chapter 7, *Prosperity Unleashed: Smarter Financial Regulation*, Norbert J. Michel, Editor (The Heritage Foundation: 2017) http://thf-reports.s3.amazonaws.com/2017/ProsperityUnleashed.pdf.

[120] A decision would need to be made regarding the Rule 502(b) disclosure requirements with respect to sales to non-accredited investors if the accredited investor concept is retained.

[121] There would need to be reasonable, administrable look-through rules if beneficial ownership were to replace the holder of record threshold. This problem has largely been solved by the tax system with respect to income reporting.

of non-insider share value (analogous to public float) – call this threshold A – and its shares were not traded on a venture exchange, alternative trading system (ATS) or national securities exchange. Secondary sales would be restricted.[122]

Public companies could engage in general solicitation and would be (1) above a specified measure of size (threshold B) or (2) have shares traded on a national securities exchange (or, at the issuer's option, an ATS). Disclosure obligations would be scaled based on some measure of size (probably public float). This is the category that most companies that are full reporting companies, smaller reporting companies, emerging growth companies and perhaps the largest Regulation A companies would fall into.

Companies that were neither "public" nor "private" would be intermediate "quasi-public" or "venture" companies. They could engage in general solicitation and sell to the public. Disclosure obligations would be scaled based on some measure of size (perhaps public float if traded on a venture exchange (or an ATS) or the number of beneficial owners or holders of record otherwise). These are the kind of companies that are meant to use the crowdfunding and Regulation A exemptions and would probably include some companies that are smaller reporting companies today.

Blue sky laws regarding registration and qualification would be preempted in all cases. State anti-fraud laws would remain operative.[123]

Companies would report based on the category they were in (private, quasi-public/venture or public). Disclosure obligations would be scaled within the quasi-public and public category. Registration statements should be dramatically simplified, describing the security being offered but the quarterly (10-Q), annual (10-K) and major event (8-K) reporting would become the core of the disclosure system rather than registration statements (except in the case of initial quasi-public or venture offerings (transitioning from private company status) or initial public offerings (transitioning from private or quasi-public/venture status)).

Although it is far from clear that it should be retained,[124] some accredited investor limitations measuring wealth, income or sophistication could be applied to private offerings should policy

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Moreover, in the contemplated regulatory regime, the impact of the step up from private to quasi-public status would not be so discontinuous as the step-up from private to public today, this break point would be of less importance.

[122] Attention should be paid to improving private secondary markets. If the accredited investor concept were retained, secondary sales should be fostered by an improved version of 4(a)(7). Enabling investors to realize the full value of their shares in secondary sales and promoting liquidity is an important aspect of investor protection.

[123] Blue Sky registration and qualification requirements are highly counterproductive. Capital routinely seeks to avoid the substantial delay, costs and regulatory risk of state registration and qualification requirements (especially in merit review states). There is little actual evidence that blue sky registration and qualification requirements materially improve investor protection. For a discussion of these issues, see Rutheford B. Campbell Jr., "The Case for Federal Pre-Emption of State Blue Sky Laws," Chapter 6, *Prosperity Unleashed: Smarter Financial Regulation*, Norbert J. Michel, Editor (The Heritage Foundation: 2017) http://thf-reports.s3.amazonaws.com/2017/ProsperityUnleashed.pdf. See also "Blue Sky Preemption and Covered Securities" section below.

[124] See, for example, Thaya Brook Knight, "Your Money's No Good Here: How Restrictions on Private Securities Offerings Harm Investors," Cato Institute Policy Analysis No. 833, February 9, 2018 https://www.cato.org/sites/cato.org/files/pubs/pdf/pa833.pdf; David R. Burton, "Broadening Regulation D: Congress

makers wish to limit those who may invest in private companies. In that case, however, something similar to the current section 4(a)(2) exemption or a statutory exemption for micro issuers would need to remain. Otherwise, a few people starting a bar, restaurant, retail store or service business would run afoul of the securities laws.

To accomplish disclosure reform while maintaining the basic current exemption structure, Congress would need to amend:

1. Securities Act Schedule A (which currently contains a list of 32 disclosure requirements and is about 5 pages in length)
2. Securities Act sections 4A (crowdfunding), 7 and 10 (relating to registration statements and prospectuses)
3. Securities Exchange Act sections 13, 14, 14A, 16 and 21E (relating to periodic and other reports, proxies, shareholder approvals, disclosure concerning directors, officers and principal shareholders and the safe harbor relating to forward looking statements)[125]

A revised Schedule A would list all disclosure requirements applicable to a fully reporting public company and also indicate which provisions did not apply to smaller reporting companies and companies falling into other categories. It would, in effect, become the roadmap to which companies had to comply with which disclosure requirements.

Implementing the complete reform program outlined above would involve substantial changes to other provisions in the law, notably sections 3, 4 and 4A of the Securities Act (relating to exempted securities, exempted transactions and crowdfunding, respectively). This would replace the current patchwork of 13 different exemptions, each with a different set of exemption and disclosure rules, with three major issuer categories (private, quasi-public ("venture") and public) and two scaled disclosure categories (larger and smaller) within the quasi-public ("venture") and public exemption categories.

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Should Let More People Invest in Private, High-Growth Companies," Heritage Foundation Backgrounder No. 3137. August 15, 2016 http://thf-reports.s3.amazonaws.com/2016/BG3137.pdf; David R. Burton, "Improving Entrepreneurs' Access to Capital: Vital for Economic Growth," Heritage Foundation Backgrounder No. 3182, February 14, 2017 https://www.heritage.org/sites/default/files/2017-02/BG3182.pdf.

[125] In addition, conforming amendments elsewhere in the Securities Act and the Securities Exchange Act would need to be made.

## PREPARED STATEMENT OF JOHN C. COFFEE, JR.

ADOLF A. BERLE PROFESSOR OF LAW, DIRECTOR OF THE CENTER ON CORPORATE GOVERNANCE, COLUMBIA LAW SCHOOL

APRIL 5, 2022

Chairman Brown, Ranking Member Toomey, and fellow Members of the Committee, thank you for inviting me today. I must begin with a very simple message: the law of insider trading has been for too long the product exclusively of judicial decision-making. Insider trading is effectively a "common law" crime that has evolved without legislative direction. Yet, it is the Congress' job to state the criminal law because it alone is the voice of the community that can reach a truly democratic decision. Letting insider trading law develop on a simply common law basis ensures that there will be inter-Circuit disparities, that the law will expand in irregular and sometimes spasmodic movements, and that the public at large will be excluded from these deliberations.

H.R. 2655 was an effort, I believe, to correct this problem and establish a clearer legislative definition of insider trading. But since its passage by the House in 2021, there have been two major developments that, I suggest, the Senate should also address:

First, although H.R. 2655 was originally intended to eliminate the "personal benefit" requirement, this provision was eliminated or downsized at the last minute.[1] Nonetheless, to the extent there is any consensus today, that consensus is probably stated best in the Report of the Bharara Task Force on Insider Trading (2020), which explicitly calls for the elimination of the "personal benefit" requirement as a major obstacle to the prosecution of insider trading.[2] That Task Force, chaired by the former U.S. Attorney for the Southern District of New York, was staffed primarily by former prosecutors, SEC enforcement officials, and judges (with a sprinkling of law professors), and it was bipartisan. It found, as I explain later, that the "personal benefit" requirement "generated a disproportionate share of confusion and uncertainty," produced "incongruent results," and allowed clearly wrongful conduct to escape the law's reach.[3]

Second, in a recent case, United States v. Blaszczak,[4] the Second Circuit agreed that insider trading can be prosecuted under certain other Federal statutes,[5] and, in such cases, there was no need to prove that a "personal benefit" was paid or promise to the tipper. However, in Blaszczak, defendants appealed this outcome on two grounds: (1) they argued that the material information that was tipped did not constitute "property" because it was developed by the Government in an effort at regulation (and not as a property holder), and (2) the various Federal statutes applicable to insider trading had to be read consistently ("in pari materia" in legal parlance) and all therefore required a showing of a personal benefit. The Supreme Court granted certiorari on both questions, but later, at the request of the Solicitor General, remanded to the Second Circuit for it to reconsider its decision in Blaszczak in the light of an intervening Supreme Court decision.[6]

The net result is to leave as at a moment of great uncertainty. To illustrate, suppose the Federal Reserve were to decide to significantly raise interest rates. If one could trade in the stock market based on this material nonpublic information and prior to its public disclosure, one could easily reap profits in the millions of dollars. But at present, it is uncertain whether this violates the law. To be sure, the Second

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[1] Proposed Section 16A(c)(1)(D) does state such a requirement ("for a direct or indirect personal benefit"). Although prosecutors need not rely on clause (D) and could instead rely on (A), (B), or (C), there is an ambiguity as to whether all these sections should be read in pari materia. Given that the Supreme Court granted certiorari on this question in Blaszczak (as later explained), I would strongly recommend explicitly rejecting the "personal benefit" requirement.

[2] For the record, I was a member of this Task Force.

[3] See Report of the Bharara Task Force on Insider Trading (2020) (at pp. 15–16).

[4] 947 F.3d 19 (2d. Circ. 2019).

[5] The defendants in Blaszczak were convicted under 18. U.S.C. 1343 and 18 U.S.C. 1348, but were acquitted under the Rule 10b-5 charge (probably because the jury saw no evidence of a "personal benefit").

[6] Blaszczak v. United States, 2021 U.S. LEXIS 93, 141 S. Ct. 1040 (vacating and remanding to the Second Circuit for further consideration in light of Kelly v. United States, 140 S. Ct. 1565 (2020)). Kelly involved the "BridgeGate" scandal in New Jersey in which certain officials working under the New Jersey Governor allegedly cut off access to several lanes of the George Washington Bridge to residents of Fort Lee as a political reprisal. The Supreme Court reversed their convictions on the grounds that such a political retaliation did not offend Federal fraud statutes because no property was taken or sought. Kelly was a decision that in turn relied on Cleveland v. United States, 531 U.S. 12 (2000), which found that video poker licenses issued by the State were not "property" in the hands of the State, because the State was acting as a regulator, not as a property holder.

Circuit will eventually decide the case remanded to it, and the losing side will predictably appeal to the Supreme Court. But even if the Supreme Court takes this case, its decision may only decide the issue over a narrow factual range. Characteristically (and properly), courts rule narrowly.

More is needed. Legislation could do much better and establish general principles.

**The Current Statutory Law on Insider Trading**

At present, the only statutory foundation for the prohibition of insider trading are a few short words in Section 10(b) of the Securities Exchange Act of 1934, which forbid the use of any "*manipulative* or *deceptive* device or *contrivance* in contravention of such rules as Commission may prescribe . . . " (emphasis added). There is no doubt that Congress wants insider trading prohibited, as it has several times passed legislation raising the penalties for insider trading. [7] But it has left the definition of insider trading to the courts.

Meanwhile, the case law has developed in different directions in different circuits. In all Circuits, there is both the "Classical Theory" of insider trading and the Misappropriation Theory, but in the Second Circuit there is also a theory recently articulated in United States v. Martoma [8] that information provided by the tipper to the tippee with the intention to benefit the tippee also violates Rule 10b-5. This expanded "gift theory," while derived from Dirks v. SEC, [9] goes further than the law in any other Circuit to reach persons who receive material confidential information (without paying or promising any person benefit). Also in Martoma, the Government took the position that there was no longer any need to establish a "meaningfully close personal relationship" between the tipper and the tippee. [10] Without criticizing Martoma, the point here made is that the Federal courts have not been able to create a reasonably uniform body of law.

Other issues also are highly uncertain that are unrelated to the "personal benefit" issue (which involves the relationship of the tipper and tippee). Let me give just two examples: First, the SEC has just succeeded in convincing a district court to accept a new and novel legal theory that prohibits what is called "shadow trading." In SEC v. Panuwat, [11] the district court refused to dismiss an SEC action brought against an employee of a company that was about to be acquired; the employee did not buy shares of either his company or the acquiring company, but instead bought stock in a company similar to his own because he guessed (correctly) that the acquisition of his company would drive up the price of similar companies. Reasonable people can disagree about the wisdom of this new theory (I was surprised that the SEC brought this case). But my point is this type of significant extension of the criminal law should be a decision for the legislature.

To give a second example, suppose that a defendant finds a way to "hack" into a company's information system to steal confidential, market-moving information. This conduct may (or may not) violate computer privacy statutes, but, even if it does, that will not help the SEC, which in fact is the principal enforcer of insider trading law (in terms of cases filed), as the SEC can only sue based on prohibitions in the Federal securities laws. In truth, the SEC has been able on at least one occasion in the Second Circuit to reach such a "hacking" case, [12] but it is very uncertain whether other Circuits would follow it. H.R. 2655 would correct this problem, legislating a general prohibition that would reach virtually any form of "wrongful" hacking.

**The "Personal Benefit" Requirement**

The "personal benefit" originated with Dirks as a seemingly "objective" means of distinguishing between (1) the self-serving use of corporate information that breached a duty owed to the shareholders (or the source of the information), and (2) a legitimate (or at least innocuous) use of the information. Also, the Court may have believed that it was important to protect institutional investors who might otherwise be chilled from engaging in communication with the corporations in which they invested. But experience with the "personal benefit" requirement has shown at least three problems that regularly recur:

[7] See, e.g., Insider Trading Sanctions Act of 1983 (ITSA) (increasing civil penalty to three times the gain or loss avoided and raising criminal fine), Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSEA) (raising prison sentence and maximum penalty and authorizing SEC to pay whistleblowers).

[8] 894 F.3d 64 (2d Cir. 2018) (as corrected).

[9] 436 U.S. 646 (1983).

[10] See United States v. Martoma, 894 F.3d at 71 to 72.

[11] 21-CV-6322 (N.D. Cal. January 14, 2022) (denying motion to dismiss).

[12] See SEC v. Dorozhko, 574 F.3d 42, 48-50 (2d Cir. 2009).

First, it protects and immunizes defendants from liability in some cases that involve obviously wrongful behavior. Suppose, for example, an activist investor has learned material nonpublic information about Corporation X (possibly legitimately), and an executive at that investor tips that information to a hedge fund who trades on it. But the latter hedge fund has not paid or promised anything for this information. Thus, it has the defense that it paid no personal benefit to the tipper and so cannot be held liable. Still, there may have been an implicit, unstated understanding: the tippee who benefitted in this case would be expected to reciprocate and tip its tipper in a future case. Both sides would be wise enough to make no explicit promise (or even hint at one). Norms of reciprocity are common in most networks where repeat players interact. Only a fool would make an illegal promise to reciprocate when a silent payback (months later) will work.

Second, disparities are likely under the fact-specific character of this standard. For the law to apply, do the parties have to be very close friends or just interacting market participants who see that reciprocation can benefit both? Circuits now disagree. Moreover, the more the standard is fact-specific, the more the likelihood that circuits will disagree.

Third, prosecutors may be unwilling to investigate in detail if their only chance of winning a conviction depends on finding a fact (a quid pro quo) that can be easily hidden.

So what is the best alternative? Congress should direct Federal courts to focus not on the specific case (whether a quid was paid for a quo), but on the more general issue of whether the information was "wrongfully" taken, used or communicated. That is the Bharara Task Force Report's position. This approach does not make insider trading either a strict liability crime or a crime of simple negligence, but requires culpable behavior.

**Whose Property Is It?: The Case of Governmental Information**

Should the Government have the right to protect its confidential information—at least to prevent others from trading on it to overreach public investors? This is not a constitutional issue. It is simply requires the legislature to speak clearly and bar the tipping of, or trading on, such information. If statutes such as the mail and wire fraud statutes were revised to cover not just the theft or misappropriation of property, but also of information that the Government had a legitimate interest in keeping confidential, such legislation would be legitimate and enforceable.

**What Then Should Be Done to H.R. 2655?**

There are many ways to skin the cat! One way would be to add a new subsection (c) to proposed Section 16A, stating that:

> (c) It shall not be necessary that any person trading while in possession of such information (as proscribed by subsection (a), or making the communication (as proscribed by subsection (b), (i) have paid or promised any benefit (monetary or otherwise) to the tipper (or on its behalf) or to any person in the chain of communication, or (ii) know the specific means by which the information was obtained or communicated, so long as the person trading while in possession of such information or making the communication, as the case may be, was aware, or recklessly disregarded, that such information was wrongfully obtained or communicated.

To ensure that there was no possible confusion, I would take "old" Section 16A(c) (Standard and Knowledge Requirement), renumber it as "(d)", and revise its subsection (1)(d) to read as follows:

> (D) a breach of any fiduciary duty to shareholders of an issuer, including—
> (i) an existing or future pecuniary gain or reputational benefit; or
> (ii) a gift of confidential information to a relative or friend.

With those changes, H.R. 2655 would better arm prosecutors, while still requiring "wrongful" behavior by the criminal defendant. And it would end the "common law" nature of the crime of insider trading. But if the "personal benefit" standard is retained, I am afraid that in its practical effect, H.R. 2655 would be more a step backward than a step forward.

**RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN BROWN FROM ROBERT J. JACKSON, JR.**

**Q.1.** Please provide any additional comments on the benefits of insider trading legislation.

**A.1.** The uncertainty created by our outdated, judge-made insider-trading law leads investors to question the fairness of our markets while leaving legitimate market participants unsure about the rules of the road. Congress' failure to act has often left ordinary investors asking whether financial markets are stacked in favor of those who skirt the rules—a question on which our law should leave no doubt.

That's why, shortly after my confirmation to be Commissioner of the U.S. Securities and Exchange Commission (SEC), I joined Preet Bharara, the former United States Attorney for the Southern District of New York, in calling for a national task force on the law of insider trading.[1] The task force, which included a bipartisan group of prosecutors, defense counsel, legal academics and judges with decades of experience enforcing, interpreting, and advising clients regarding our securities laws, unanimously concluded that Congress should clarify the law of insider trading—and I agree.[2]

The Insider Trading Prohibition Act would do just that, closing glaring gaps in our insider-trading law. Consider, for example, a hacker who steals American consumers' data from a publicly traded company. As the Committee knows, our companies are in a constant battle to protect themselves from hackers.[3] There is troubling evidence that hackers who succeed in stealing data also trade before the hack is known to the public—so that our markets help finance the very cyberattacks that put Americans' privacy at risk.[4]

Most investors would expect this hacker to be held accountable for insider trading. But our antiquated insider-trading law often does not reach this case, because that law requires the Government to show that information was obtained in breach of a duty or by way of deception.[5] Many hackers attack our companies not through deception but by brute-force tactics that simply overwhelm our defenses.[6] From the perspective of the judges who have made our insider-trading law, that distinction might make a difference. But for ordinary investors, the idea that the law of insider trading allows

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[1] Preet Bharara and Robert J. Jackson, Jr., "Insider Trading Laws Haven't Kept Up With the Crooks", *N.Y. Times* (Oct. 9, 2018).

[2] "Report of the Bharara Task Force on Insider Trading 20" (January 2020).

[3] SEC Commissioner Robert J. Jackson, Jr., "Corporate Governance: On the Front Lines of America's Cyber War" (March 15, 2018) (in 2017, more than 90 percent of American public companies suffering a cybersecurity breach did not promptly disclose that fact to investors on securities filings). Since then, the SEC has proposed important new rules requiring prompt disclosure of cybersecurity breaches. See U.S. Sec. and Exch. Comm'n, Proposed Rule: Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure (March 9, 2022).

[4] See Joshua Mitts and Eric Talley, "Informed Trading and Cybersecurity Breaches", 9 *Harv. Bus. L. Rev.* 1 (2019) ("[O]ur findings appear strongly consistent with the proposition that arbitrageurs can and do obtain early notice of impending [cyber] breach disclosures, and that they are able to profit from such information.").

[5] 15 U.S.C. §78j(b) (forbidding the use of any "manipulative or deceptive device or contrivance in contravention of such rules as the [SEC] may prescribe").

[6] SEC v. Dorozhko, 574 F.3d 42, 47 (2d Cir. 2009) ("In our view, misrepresenting one's identify in order to gain access to information that is otherwise off limits, and then stealing that information is plainly 'deceptive' within the ordinary meaning of the word. It is unclear, however, that exploiting a weakness in an electronic code to gain unauthorized access is 'deceptive,' rather than being mere theft.").

hackers to profit from the destruction they cause raises doubts about the fundamental fairness of our markets.

The Act would address that gap. Among the "most significant impact[s]" of the law, according to practitioners, would be to clearly outlaw trading on information obtained through cybersecurity hacks.[7] All agree that, without Congressional action, it will remain unclear whether such trading is prohibited by American securities law. I cannot see why our law should countenance the possibility that profits obtained through illicit trading are funding the cyberattacks that our Government, and American public companies, are working so hard to combat.[8]

The hearing left little doubt that it is time for Congress to clarify the law in this area. For example, one witness opposing adoption of a Federal insider-trading statute thought that the Act should not impose liability on an insider who gives information to a trader for an "indirect" personal benefit, limiting liability only to insiders who receive direct payments in exchange for the information. To see why the Act correctly imposes liability in both cases, consider how market participants would respond to a rule limiting liability only to insiders who accept cash for divulging information to illicit traders. Rather than direct payments, insiders can be expected simply to seek other consideration—reputational benefits, future employment, and the like—in exchange for their information.

For three reasons, Congress should not design our law in this way. First, it would permit easy evasion of insider-trading law by those creative enough to demand different forms of payment for improper conduct. Second, it would favor our most-connected market participants over smaller investors, since those with ample relationships on Wall Street will find it easiest to trade information for indirect consideration. Finally, it would make our insider-trading law a trap for those who cannot afford sophisticated corporate counsel, who could easily advise paying clients how to avoid liability under this rule.

Most observers agree that our outdated, judge-made insider-trading law is ill-suited for today's markets. Congress should move promptly to update our insider-trading law to reflect the reality of our markets—and to ensure that traders who take advantage of ordinary American investors are held accountable.

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## RESPONSES TO WRITTEN QUESTIONS OF SENATOR REED FROM ROBERT J. JACKSON, JR.

**Q.1.** How would the Securities and Exchange Commission, Federal prosecutors, defense lawyers, the financial industry, and the American people all benefit if Congress were to finally define the standards for insider trading liability?

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[7] See, Insider Trading Prohibition Act, 117th Cong., S. 3990, Section 2 (prohibiting trading based on information "obtained by" "a violation of any Federal law protecting computer data" or "the intellectual property or privacy of computer users"); see also Davis Polk, "Client Memorandum: House Passes Insider Trading Bill" (May 25, 2021) ("Perhaps the most significant impact [of the Act] would be to cover hacking . . . without regard to whether the hacking method involved 'deceptive' conduct.").

[8] Mitts and Talley, supra note 4, at 14 (distinguishing insider trading of this kind from the standard case by noting that the trading may provide incentives to engage in socially counterproductive conduct).

**A.1.** Our antiquated, judge-made insider trading laws are hopelessly out of step with modern stock markets. The result is that fraudsters have been able to avoid accountability for the harm they have caused investors, while honest market participants are confused about the basic rules of the road. This makes investors more hesitant to finance American companies than they would be if they were confident in the fairness of our markets, and analysts unsure about how they can legally do their work. [1] Congressional action in this area would be beneficial for investors, insiders, and analysts alike.

**Q.2.** Why should a trader who trades based on their own information independently developed from publicly available sources have no fear of liability under the Insider Trading Prohibition Act?

**A.2.** None of the Act's prohibitions comes close to implicating investors who independently obtain information from public sources. The Act prohibits trading on the basis of information obtained or communicated "wrongful[ly]," that is, through "theft, conversion[ or] bribery," violations of Federal law protecting "computer data" or "intellectual property," misappropriation, or breach of fiduciary duty. [2] During years of experience as an investment banker, corporate lawyer, and regulator, I have not yet come upon an investor that properly uses tactics fitting those descriptions in connection with their research. [3]

**Q.3.** How would the Insider Trading Prohibition Act resolve the current ambiguity regarding whether trading on information obtained through cybersecurity hacks constitutes illegal insider trading?

**A.3.** As the Committee knows, our public companies are in a constant battle to protect Americans' most private information from cyberattacks. [4] And there is troubling evidence that hackers who succeed in stealing data also trade before the hack is known to the public—so that our markets help finance the very cyberattacks that our Government and companies are working so hard to prevent.

Most investors would expect these hackers to be held accountable for insider trading. But our antiquated, judge-made insider-trading law requires the Government to show that information was obtained in breach of a duty or by way of deception. Since many hackers attack not through deception but by brute-force tactics,

[1] See, e.g., Merton H. Miller and Charles W. Upton, "Strategies for Capital Market Structure and Regulation", in Merton H. Miller, *Financial Innovations and Market Volatility* 127 (1991) (explaining that market makers will widen spreads in the presence of informed trading); Lawrence R. Glosten and Talis J. Putnins, "Welfare Costs of Informed Trade", (AFA San Francisco Meetings, 2016) (documenting welfare costs of informed trading).

[2] Insider Trading Prohibition Act, 117th Cong., S. 3990, Section 2.

[3] Those opposing passage of the Act have repeatedly raised the concern that its prohibitions will "chill vital information-gathering." Bainbridge, supra note 20, at 243 n. 83 (quoting 167 Cong. Rec. H. 2462 (daily ed. May 18, 2021) (statement of Rep. Huzienga)). But I am unaware of an actual example of information-gathering to which the Act would apply that its opponents think it should not—save speculative claims that prosecutors will be "tempted" to make weak arguments under the Act that courts will readily reject. Id. at 236–37 (suggesting that prosecutors will argue that information overheard in public was "stolen" or "converted" for purposes of the Act).

[4] SEC Commissioner Robert J. Jackson, Jr., "Corporate Governance: On the Front Lines of America's Cyber War" (March 15, 2018) (in 2017, more than 90 percent of American public companies suffering a cybersecurity breach did not promptly disclose that fact to investors on securities filings).

trading on a successful hack may not be illegal under the insider-trading law we have today.

The Insider Trading Prohibition Act would close this gap by specifying that trading on information obtained through a "violation of any Federal law protecting" "computer data" or the "intellectual property or privacy of computer users" gives rise to liability under our securities laws.[5] As practitioners have explained, this provision reflects the "most significant impact" of the Act, and it is hard to see why Congress should not move swiftly to address the risk that hackers can profit from trading in this way.[6]

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**RESPONSES TO WRITTEN QUESTIONS OF SENATOR CORTEZ MASTO FROM ROBERT J. JACKSON, JR.**

**Q.1.** Many bills concerning Congressional insider trading are being considered—I am cosponsor of Senator Ossoff's Ban Congressional Stock Trading Act. When evaluating these different bills, what should lawmakers primarily consider to ensure the language has the most foresight? And some lawmakers have diversified into digital assets-how should lawmakers consider stopping Congressional insider trading in those securities?

**A.1.** Thank you for your leadership regarding the restriction of trading by sitting Members of Congress. I agree with the overwhelming majority of Americans: Members must not be permitted to engage in trading on the basis of information obtained in connection with their work on behalf of the American public, and evidence of such trading undermines Americans' confidence in our markets and in Congress.[1]

By requiring Members to hold their assets in a qualified blind trust, the Ban Congressional Stock Trading Act seeks to put distance between Members and decisions regarding the acquisition or disposition of those assets.[2] Drawing from our existing ethics laws, the Act would use the uniform system of qualified blind trusts to achieve that goal.[3]

In theory, qualified blind trusts limit knowledge of the trust's assets and trading activity to the trustee. In practice, however, the history of qualified blind trusts, particularly in the legislative branch, raises questions whether those restrictions are consistently observed.[4] In response to your question about how policymakers might anticipate concerns regarding future developments in this area, then, I note that the use of qualified blind trusts for this important purpose would rely heavily on the rules governing such

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[5] Insider Trading Prohibition Act, 117th Cong., S. 3990, Section 2.

[6] Davis Polk, "Client Memorandum: House Passes Insider Trading Bill" (May 25, 2021).

[1] Karl Evers-Hillstrom, "Three in Four Voters Support Banning Lawmakers From Trading Stocks: Poll", *The Hill* (Jan. 6, 2022).

[2] Ban Congressional Stock Trading Act of 2022, S. 3494, at §2; see also, Bud W. Jerke, "Comment, Cashing in on Capitol Hill: Insider Trading and the Use of Political Intelligence for Profit", 158 *U. PA. L. Rev.* 1451, 1452 (2010) (arguing for this approach over a decade ago).

[3] See Ethics in Government Act of 1978, Pub. L. 95-521, 5 U.S.C. app. 4 §102(f)(3) et seq. (providing the definition, and procedure for certification, of qualified blind trusts).

[4] See, e.g., Preventing Unfair Trading by Government Officials: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Financial Services, 111th Cong. (2009) (proposed statement of Alan J. Ziobrowski, Robinson College of Business, Georgia State University), at 4-5 (noting that Members who have voluntarily placed assets in qualified blind trusts have not always observed these limitations, and contending that the "rules [must] be tightened to clearly define a blind trust[,] making them absolutely blind"; see also Len Costa, "A Wink and a Nod", *Legal Aff.* (2006) (describing this history).

trusts—and enforcement of those rules against both trustees and Members. Thus, lawmakers should consider whether modifications to those rules, and the procedures and resources for enforcing them, are necessary in order for qualified blind trusts to serve the purposes specified for them by the Act.

Alternatively, Congress might consider drawing on the experience of certain public companies seeking to reduce the risk of opportunistic trading. Some companies, for example, require insiders to specify any purchases or sales of assets to occur in a given year irrevocably in advance and then divide those transactions equally over each trading day of the year, eliminating the discretion that gives rise to opportunistic trading. Alternatively, any trades might be specified well in advance and executed on a random date chosen by a third party. [5] Although these approaches would have their own costs, they would avoid reliance on trustees to keep information about trading activity confidential from Members.

**Q.2.** Judges have defined a fair bit of what constitutes information-sharing, insider trading from acceptable forms of data-gathering and research that are part of any healthy, functioning financial marketplace. How do you think the Insider Trading Prohibition Act clarifies these differences?

What mechanisms need to be in place to ensure consistency and equality of enforcement?

**A.2.** The distinction between improperly obtained information and socially productive research is a famously fine one. [6] As your question suggests, the courts have struggled with that distinction for generations. Since the principal authority for prohibiting insider trading is a Depression-era statute sounding in fraud, the courts have emphasized a breach of duty, or a deception, as a predicate for liability. The result is confusion that leaves both defendants and investors unclear about what the law is—which both discourages valuable research and raises questions among investors about the fairness of our markets.

Under current law, for example, whether an insider who shares information with a trader is held liable depends on whether the insider received a personal benefit from tipping the trader. And whether such a benefit exists in any particular case is a subject on which judges often disagree. For example, the Second Circuit concluded in 2014 that a personal benefit must be "objective, consequential, and represent[] at least a potential gain of a pecuniary or similarly valuable nature" to sustain insider-trading liability. [7] The next year, the Ninth Circuit came to the opposite conclusion in a similar case. [8] Thus, for years defendants and investors had to

[5] See, e.g., M. Todd Henderson, "Every CEO Should Follow Mark Zuckerberg's Stock-Trading Example", *Wall St. J.* (Dec. 27, 2021) (documenting these practices).

[6] Henry G. Manne, "Insider Trading and the Stock Market" (1966); A.C. Pritchard, "Justice Lewis F. Powell, Jr., and the Counterrevolution in the Federal Securities Laws", 52 *Duke L.J.* 841, 931 (2003).

[7] United States v. Newman, 773 F.3d 438, 452 (2d Cir. 2014).

[8] United States v. Salman, 792 F.3d 1087 (9th Cir. 2015) (Rakoff, J., sitting by designation) ("To the extent Newman can be read to go so far, we decline to adopt it."). To underscore the uncertainty under current law as to whether a personal benefit exists in any particular insider-trading case, I note that the author of the Ninth Circuit's Salman opinion ordinarily sits in the Southern District of New York, which is within the jurisdiction of the Second Circuit. That is:

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do their work without knowing what the law of insider trading was. And that is regarding an insider-trading question that the Supreme Court eventually "*easily* resolve[d]."[9]

The Insider Trading Prohibition Act makes clear that an insider who shares information for a "direct or indirect personal benefit" can be held liable for trading on the basis of that information. Contrary to concerns about the scope of a law that reaches those who reveal corporate secrets for "indirect" benefits, the Act adopts the Supreme Court's view that payments for wrongdoing are not always rendered in cash.[10] Whether insiders receive a check, or future employment, for divulging information is irrelevant to whether investors face a level playing field. It should be irrelevant to our insider-trading law, too.

During the hearing, I was puzzled that those expressing concerns about the scope of the Act omitted from their analysis the extensive due-process protections that insider-trading defendants enjoy—protections that most litigants can only envy.[11] Before the SEC brings a civil enforcement action, the Commission's Staff must usually obtain a Formal Order of Investigation from the most senior officers of the agency.[12]

Following an investigation, the Staff ordinarily gives the defendant and her counsel the opportunity to make written submissions directly to the Commissioners regarding the defendant's views of the Staff's allegations.[13] Months or years later, the Staff may make a recommendation that the case be litigated or settled.[14] And that action can only be adopted by a majority vote of the Commissioners themselves, usually following a closed Commission meeting in which the merits of the matter are discussed in detail.[15]

These are important procedures that ensure that Commission action reflects close consideration of the facts of each case—and they all occur before civil proceedings, to which additional procedural protections attach, commence. Procedures of this kind should give

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the law in this area is so unclear that a judge from the Second Circuit, sitting by designation in the Ninth Circuit, wrote an opinion declining to adopt the views of the Second Circuit.

[9] Salman v. United States, 580 U.S. 89, 94 (2016) (emphasis added); see also United States v. Blaszczak, 947 F.3d 19, 35 (2d Cir. 2019) (declining to extend Newman to the fraud provisions of Title 18).

[10] Salman, 580 U.S. at 94.

[11] For example, one article advocating against passage of Federal insider-trading legislation speculates that the statute would "likely" expand the scope of liability because it will open new paths for "aggressive prosecutors" to pursue cases under novel theories. Stephen P. Bainbridge, "A Critique of the Insider Trading Prohibition Act of 2021", 2021 *U. Ill. L. Rev.* Online 231 (2022). Although the article describes these outcomes as "likely" on a dozen occasions, it makes no mention of the extensive procedural safeguards designed to address those concerns, so one cannot say what weight this critique gives to the institutional context in which these decisions are made. Id.

[12] Securities and Exchange Commission, Informal and Other Procedures, 17 CFR §202.5(d).

[13] Id.; see also, "Securities and Exchange Commission Division of Enforcement Office of Chief Counsel", Enforcement Manual 4 (2017). This process, known as providing a potential defendant with a "Wells Notice," is named for John A. Wells, who oversaw an advisory committee charged with examining the "due process implications of [SEC] enforcement practices." SEC, "Advisory Committee on Enforcement Policies and Practices: Request For Comment" (issued March 2, 1972). By rule, materials submitted by a defendant in response to a Wells Notice must be "forwarded to the Commission in conjunction with a Staff memorandum." Securities and Exchange Commission, Informal and Other Procedures, 17 CFR §202.5(c).

[14] Robert Khuzami, Dir., Division of Enforcement, Testimony on Examining the Settlement Practices of U.S. Financial Regulators (testimony before Comm. on Fin. Servs. of the U.S. House of Representatives) (May 17, 2012) (noting that the investigative process usually takes "months or years" before producing a recommendation).

[15] Division of Enforcement Office of Chief Counsel, supra note 21, at 23 (noting that Staff should be "prepared to answer the questions that are likely to be asked by the Commissioners" in such a meeting).

commentators comfort that the SEC's enforcement of the Act will reflect detailed analysis of each case by each Member of the Commission.

**Q.3.** As an SEC Commissioner, you provided ways to think about the problem of enforcing the laws against insider trading. Does the Insider Trading Prohibition Act address the issues you identified?

**A.3.** Yes. In particular, the Insider Trading Prohibition Act would ensure that hackers who steal Americans' data from publicly traded companies cannot profit from trading before the hack is known to the public. Under current law, it is unclear whether such trading would be actionable, because that law requires the Government to show that information was obtained in breach of a duty or by way of deception. Since many hackers attack not through deception but by brute-force tactics, trading on a successful hack may not be illegal under the outdated, judge-made law of insider trading we have today.

While serving as an SEC Commissioner, I pointed this out along with Preet Bharara, the former U.S. Attorney for the Southern District of New York. We argued that ordinary investors would be astonished to discover that Federal securities law lets hackers profit from the destruction they cause. The Insider Trading Prohibition Act would close this gap, leaving no doubt that trading on the basis of information obtained through cyberattacks is prohibited by Federal securities law. Congress should act promptly to ensure that such trading cannot finance those who seek to steal Americans' most private information.

Still, important gaps in our insider-trading law remain. As I noted at the hearing, foreign companies domiciled in countries like China and Russia now raise significant funds from American investors by listing on U.S. stock exchanges.[16] Unlike executives at American corporations, however, insiders at foreign firms are not subject to immediate disclosure of transactions in their company's stock. So there is risk that foreign-firm insiders can take advantage of ordinary investors through opportunistic trading.[17]

In a paper recently featured in The Wall Street Journal, I worked with the Wharton School's Daniel Taylor and Bradford Lynch to study that question.[18] Drawing on a unique dataset of tens of thousands of paper filings with the SEC describing sales of stock over a 5-year period, we analyzed whether foreign-firm insid-

[16] As a formal matter, these firms often list on U.S. Exchanges by way of American Depository Receipts or American Depository Shares, which generally represent an interest in the shares of a company domiciled outside the United States that have been deposited with a U.S. bank or trust.

[17] Under Section 16(a) of the Securities Exchange Act of 1934, officers and directors of U.S. public companies are required to publicly disclose certain transactions in their company's stock on the SEC's Form 4. In 2002, Congress passed the Sarbanes-Oxley Act, mandating that insiders at U.S. companies report their trades under Section 16(a) within 2 business days and file Form 4 electronically. U.S. Sec. and Exch. Comm'n, Final Rule, Ownership Reports and Trading by Officers, Directors and Principal Security Holders (2002). But the SEC exempted foreign private issuers from these requirements in an effort to encourage those issuers to list on U.S. exchanges. See Steven Davidoff, Rhetoric and Reality: A Historical Perspective on the Regulation of Foreign Private Issuers, 79 *U. Cin. L. Rev.* 619, 621 (2011).

[18] Liz Hoffman, "Chinese Executives Sell at the Right Time, Avoiding Billions in Losses", *Wall St. J.* (April 5, 2022) ("Chinese corporate insiders have avoided billions of dollars in losses by making well-timed share sales over the past several years, according to an academic analysis of securities filings.").

ers are able to avoid losses on their U.S.-traded stocks by selling before prices fall.[19]

The results are striking. Our data show that foreign-firm insiders avoid substantial losses by selling shares shortly before stock-price declines. This activity is concentrated in firms domiciled in China and Russia. Indeed, when insiders of U.S.-listed Chinese companies sell shares, the median company's stock price falls by 23 percent during the 12 months following the sale; when insiders at Russian companies sell, the median firm's stock drops 21 percent over the next year. We estimate that insiders at Chinese-domiciled, U.S.-listed companies alone have avoided over $10 billion in losses as a result of well-timed stock sales.

That's why the Holding Foreign Insiders Accountable Act of 2022, which was introduced in the Senate this month, is so important. The bill would require foreign-firm insiders to disclose their trades under the same rules that apply to executives at American companies.[20] Allowing foreign firms to be less transparent about insider-trading activity than their U.S. counterparts is the kind of gap in our law that creates doubt as to whether our markets create the level playing field investors deserve. Congress should move promptly to close that gap.

**Q.4.** Can insider knowledge gained from a corporate friend constitute insider trading under the Insider Trading Prohibition Act?

**A.4.** Yes; in particular, the Act specifies that trading on information conveyed by a corporate insider can give rise to insider-trading liability if the information is communicated wrongfully. The Act also makes clear that trading on information from a corporate tipper is prohibited if the tipper breaches her fiduciary duty to shareholders "for a direct or indirect personal benefit."[21]

Contrary to concerns about the scope of a law that reaches those who reveal corporate secrets for "indirect" benefits, the Act properly adopts the Supreme Court's commonsense view that payments for wrongdoing are not always rendered in cash. Rather than encourage insiders to reveal information for noncash consideration, the Act properly reaches insiders who choose to divulge secrets for personal gain.

**Q.5.** Can the hackers of corporate and investor databases face insider trading charges under the Insider Trading Prohibition Act?

**A.5.** Yes—and some of those hackers will escape liability under our insider-trading laws unless Congress acts. As your question suggests, there is troubling evidence that hackers who succeed in stealing data also trade before the hack is known to the public—so that our markets help finance the very cyberattacks that put Americans' privacy at risk.

The Insider Trading Prohibition Act would close this gap by specifying that trading on information obtained through a "violation of any Federal law protecting" "computer data" or the "intellectual property or privacy of computer users" gives rise to liability

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[19] See Robert J. Jackson, Jr., Bradford Lynch, and Daniel J. Taylor, "Holding Foreign Insiders Accountable" (April 2022).

[20] Holding Foreign Insiders Accountable Act of 2022, S. 4127, Section 2(a).

[21] Insider Trading Prohibition Act, 117th Cong., S. 3990, Section 2.

under our securities laws.[22] As practitioners have explained, this provision reflects the "most significant impact" of the Act, and it is hard to see why Congress should not move swiftly to address the risk that hackers can profit from trading in this way.[23]

**Q.6.** Which of the Bharara Task Force recommendations requires Congressional action to implement?

**A.6.** The task force was comprised of a bipartisan group of securities-law experts from academia, private practice, and the judiciary, as well as former senior officials of both the SEC and the Department of Justice. The group studied submissions from the Financial Industry Regulatory Authority, the National Association of Criminal Defense Lawyers, and the U.S. Chamber Institute for Legal Reform.

On the basis of these submissions, the task force unanimously concluded that "[r]eform that simplifies, clarifies, and modernizes insider trading form is necessary and long overdue," and that action by Congress is "the best vehicle for such reform." The task force was also unanimous in its view that, while other measures such as SEC rulemaking "could provide incremental benefits," "any steps short of a new statute will continue to be burdened by the uncertainty that accompanies existing common law."[24]

I agree. Decades of judicial decisions have left the law of insider trading in a confused state that treats like cases differently on the basis of distinctions that make little economic sense. The reason, of course, is that the courts are interpreting a statute that makes no mention of insider trading, and so is a poor fit for this purpose. Both investors and insiders deserve to know what the law permits and what it prohibits with respect to trading on material nonpublic information, and at this stage only Congressional action can provide meaningful answers to those questions.

**Q.7.** The Bharara Task Force recommendation focused on "wrongful" use of material nonpublic information, not exclusively on "deception" or "fraud." Why is that distinction important?

**A.7.** Not all socially harmful insider trading involves fraud or deception. To see why, consider the case of a hacker who steals Americans' data from a publicly traded company. As this Committee knows, our companies are in a constant battle to protect themselves from hackers. There is troubling evidence that hackers who succeed in stealing data also trade before the hack is known to the public—so that our markets help finance the very cyberattacks that put Americans' privacy at risk.

But not all hacking involves fraud or deception. Instead, many hackers attack our companies through brute-force tactics that simply overwhelm our defenses. So, as the Second Circuit has explained, it is not clear that under current law trading on information obtained in this way gives rise to insider-trading liability.[25]

[22] Insider Trading Prohibition Act, 117th Cong., S. 3990, Section 2.
[23] Davis Polk, "Client Memorandum: House Passes Insider Trading Bill" (May 25, 2021).
[24] "Report of the Bharara Task Force on Insider Trading 21" (January 2020).
[25] SEC v. Dorozhko, 574 F.3d 42, 47 (2d Cir. 2009).

Yet such trading might finance socially counterproductive attacks on American companies.[26]

That's why it is so important that Congress make clear that "wrongful" trading—which the Act defines to include trading on information obtained in violation of law protecting computer data—is prohibited. And that's why a Depression-era statute that prohibits fraud is poorly suited to address insider trading in modern American stock markets.

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**RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARNOCK FROM ROBERT J. JACKSON, JR.**

**Q.1.** What are the medium and long-term ramifications on our capital markets by not having laws prohibiting insider trading written into statute?

**A.1.** The uncertainty created by our outdated, judge-made insider-trading law leads investors to question the fairness of our markets while leaving legitimate market participants unsure about the rules of the road. Congress' failure to act has often left ordinary investors asking whether financial markets are stacked in favor of those who skirt the rules—and invited questions about how analysts can do their jobs. This makes investors more hesitant to finance American companies than they would be if they were confident in the fairness of our markets, and analysts unsure about how they can legally do their work.

**Q.2.** Do other industries that trade in nonsecurities, such as energy, currencies, and agriculture commodities, experience insider trading perpetuated by bad actors? Would it be beneficial to ensure that insider trading statutes exist in these markets?

**A.2.** Yes: commodities markets experience trading on the basis of misappropriated confidential information—and that trading can harm investors. That's why Congress, in the Dodd-Frank Act, amended the Commodity Exchange Act to include Section 6(c)(1), which gives the U.S. Commodity Futures Trading Commission (CFTC) new enforcement authority mirroring the SEC's authority under Rule 10b-5.[1]

The SEC has pursued insider-trading cases under Rule 10b-5 for more than a generation, producing the confused common law that risks harm for investors and insiders alike. By contrast, the CFTC's use of its enforcement authority under Section 6(c)(1) is relatively new. The courts have only begun to identify the questions in this area that may require Congressional clarification.[2] To the degree that such questions produce the kinds of consistent confusion that now characterizes insider-trading doctrine under our securities laws, further Congressional action may be warranted.

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[26] Mitts and Talley, supra note 4, at 14.

[1] See Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376, (2010), 7 U.S.C. §6c(a)(1); compare 17 CFR §180.1 with id. §240.10b-5.

[2] See, e.g., CFTC v. Monex Credit Company, No. 18-55815 (9th Cir. 2019) (providing an analysis of the "extent of [the CFTC's new enforcement] powers" under Dodd-Frank).

## RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARNOCK FROM M. TODD HENDERSON

**Q.1.** What are the medium- and long-term ramifications on our capital markets by not having laws prohibiting insider trading written into statute?

**A.1.** Response not received in time for publication.

**Q.2.** Do other industries that trade in nonsecurities, such as energy, currencies, and agriculture commodities, experience insider trading perpetrated by bad actors? Would it be beneficial to ensure that insider trading statutes exist in these markets?

**A.2.** Response not received in time for publication.

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## RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARNOCK FROM DAVID R. BURTON

**Q.1.** What are the medium- and long-term ramifications on our capital markets by not having laws prohibiting insider trading written into statute?

**A.1.** Response not received in time for publication.

**Q.2.** Do other industries that trade in nonsecurities, such as energy, currencies, and agriculture commodities, experience insider trading perpetrated by bad actors? Would it be beneficial to ensure that insider trading statutes exist in these markets?

**A.2.** Response not received in time for publication.

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## RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN BROWN FROM JOHN C. COFFEE, JR.

**Q.1.** Please provide any additional comments on the benefits of insider trading legislation.

**A.1.** During the April 5th hearings on the Insider Trading Prohibition Act, there was disagreement about the wisdom of the Act's inclusion of the "personal benefit" standard. The draft bill retains it, but others (such as the Bharara Task Force on Insider Trading) strongly recommended that it be deleted. This debate may seem abstract, but a recent example drives home its importance. The facts of a well-known case, United States v. Newman, 773 F.3d 438 (2nd Cir. 2014), illustrate how sophisticated hedge funds can evade the insider trading prohibition if the "personal benefit" requirement is retained. There, one portfolio manager at a hedge fund tipped another portfolio manager at a different hedge fund that he had learned from sources inside two companies that their soon-to-be-announced earnings would be down. Both traded on this material nonpublic information, with one earning $4 million and the other earning $68 million—for a total of $72 million based on this exchange of material nonpublic information. This is modern, big-time insider trading, and the Insider Trading Prohibition Act would unfortunately permit these practices to continue.

Both defendants in Newman were convicted after a 6-week trial at the district court, but their convictions were reversed by the Second Circuit, which found that the evidence was insufficient to show that the tippee paid or directed any personal benefit to the tipper

for the information. Indeed, such payments will be rare to non-existent because sophisticated traders (such as these) know better than to demand or pay any such benefit. Rather, they understand that reciprocity is expected. In effect, there is an implicit "favor bank" on Wall Street, which requires those seeking material information to exchange future tips in return for the tip that they just profited from. Norms of reciprocity are common in many industries, including the world of investment professionals. All understand that to get information you have to provide information: to receive it, you have to pay back later with a reciprocal tip. Illustrating this understanding is the fact that the inside information in Newman flowed from one hedge fund to another almost instantly upon receipt—without anyone seeking to negotiate a personal benefit.

As a result, the Insider Trading Prohibition Act leaves a giant loophole because it will seldom (if ever) be the case that one sophisticated trader will be so stupid as to pay (or promise) a "personal benefit" to another trader. They have learned that "personal benefit" is the necessary critical element under existing insider trading law, which they can evade by not paying or promising such a benefit. Thus, in the Newman case, $72 million was made in a day by sophisticated parties who have found a way to outflank the law. The result is an unjustifiable disparity: smaller investors (or less sophisticated ones) can be convicted, but the giants escape liability.

All this can be easily corrected (and the statute then passed) if the words "for a direct or indirect personal benefit" were deleted from proposed Section 16A(c)(1)(D). With this deletion, the proposed Act would be beneficial and would cure a variety of ambiguities under current law. Absent this deletion, the proposed Act would enable sophisticated hedge funds to continue to evade the law with impunity.

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## RESPONSES TO WRITTEN QUESTIONS OF SENATOR REED FROM JOHN C. COFFEE, JR.

**Q.1.** How would the Insider Trading Prohibition Act help our courts reach more consistent and fair outcomes regarding what kind of conduct qualifies as illegal insider trading?

**A.1.** The Act does extend the law of insider trading desirably in a few new directions, most notably with respect to computer hacking and other forms of theft or embezzlement of information. A single statutory standard may also curb the tendency for different Circuits to create their own rules (as may have happened in decisions such as United States v. Martoma, 894 F.3d 64 (2nd Cir. 2017)).

On the other hand, by continuing to recognize the "personal benefit" standard in its Section 16A(c)(1)(D), this statute would permit hedge funds and other professional investors to engage in insider trading with impunity by simply not promising, paying, or requesting any personal benefit. All they need to do to escape liability is shown in United States v. Newman, 773 F.3d 438 (2nd Cir. 2014), where one hedge fund tipped another hedge fund about information that it had just learned from inside the company and the two funds made a total of $72 million in just a day of trading. Although the portfolio managers were prosecuted and convicted at the district court level, the Second Circuit overturned the conviction of the two

portfolio managers on the grounds there was no evidence that they had received, paid or promised any personal benefit in return for the material information. As a result, sophisticated traders now know that they can exchange material nonpublic information, so long as they do not give or promise any personal benefit. They will continue to tip each other, however, because Wall Street resembles a "favor bank" in which you must make deposits of information in order to make withdrawals. Even if there may be an expectation of a future reciprocal tip, this is not enough to support a criminal conviction (where the proof must satisfy the "beyond a reasonable doubt" standard). Hence, the statute, as currently written, will encourage some sophisticated parties to persist in insider trading—and successfully.

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**RESPONSES TO WRITTEN QUESTIONS OF SENATOR CORTEZ MASTO FROM JOHN C. COFFEE, JR.**

**Q.1.** I am happy (indeed, enthusiastic) to endorse legislation to "ban Congressional stock trading." I have not seen, however, the text of either your bill or Senator Warren's bill and am making no comparative assessment of them.

Many bills concerning Congressional insider trading are being considered—I am a cosponsor of Senator Ossoffs (D-GA) "Ban Congressional Stock Trading Act".

When evaluating these different bills, what should lawmakers primarily consider to ensure the language has the most foresight?

**A.1.** You need to cover stock equivalents, including instruments such as "total return" swaps, single stock futures, all options, and other derivatives that match the performance of the security. Some of these equivalents will make a professional intermediary the record or beneficial holder of the instrument; this should not matter or provide a defense. Of course, the bill need not (and probably should not) cover index funds or broadly diversified mutual funds as it would be rare for material nonpublic information from any company to enable traders to profit on such broader funds. Conceivably there is a possibility that Members of Congress might invest in indexes or other diversified funds if they knew in advance what the Federal Reserve was about to do on interest rates; but this might be better addressed by the Federal Reserve, and there is to date no indication of such trading.

**Q.2.** What language must be necessary for these bills?

**A.2.** If you provide for criminal liability in your statute, a scienter standard must be specified. I would suggest "knowingly" and would strongly advise against the use of a negligence standard for criminal liability. It is against the tradition of Anglo-American criminal law to provide for negligence-based criminal liability, and you would invite broad opposition on civil liberties grounds. In this light, you should also provide for civil liability where negligence can be used as the requisite standard. Here a variety of sanctions could be provided, including forfeiture of a portion of the Member of Congress' salary or other benefits, treble damages, and/or censure by Congress. It is also important to provide this disclosure of apparent violations not be delayed. If a Member of Congress were

facing an impending election, the critical issue for such person might be to delay disclosure of the violation until after the election (in the belief that the voters would have forgotten the misconduct by the time of the next election). Thus, any allegation discovered by the staff for which they believe they have credible evidence should be promptly disclosed. One advantage of civil liability is that enforcement is much more likely and less costly.

One last issue needs to be faced: should the proposed bill exempt Rule 10b5-1 plans (which permit corporate officers to give voting discretion to an intermediary who can then freely trade so long as it has not been tipped material nonpublic information). The analogy here would be to permit a Member of Congress to appoint a broker or bank as an agent who would trade a discretionary account. I would recommend against permitting Rule 10b5-1 plans to be so exempted, as recent experience has shown that executive officers who have established such plans receive a well above-market rate of return on them (suggesting that some material information is leaking to the agent).

**Q.3.** Some lawmakers have diversified into digital assets—how should lawmakers consider stopping Congressional insider trading in those securities?

**A.3.** If we are talking about cryptocurrencies here, I do not currently see the need to prohibit Members of Congress from investing or trading in them. Still, I might favor a more limited prohibition on the purchase of cryptos from a controlling person or affiliate of such a currency. There is considerable evidence that a few cryptocurrencies have been manipulated (for example, Tether). You may also be concerned that the founder of a currency wants to advertise it by showing that a Member of Congress invests in it. But this is a different problem from insider trading and involves the ethically dubious appearance of a Congressperson advertising for a product. My one concern about Members of Congress investing or trading in cryptos would be trading based on nonpublic knowledge about the Federal Reserve's intentions with respect to interest rates. To date, I am aware of no such example of trading in anticipation of Federal Reserve interest rate announcements, and thus it may be premature to legislate this broadly with respect to ownership of cryptos.

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## RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARNOCK FROM JOHN C. COFFEE, JR.

**Q.1.** What are the medium- and long-term ramifications on our capital markets by not having laws prohibiting insider trading written into statute?

**A.1.** Although we have long had SEC Rule 10b5 to combat insider trading, its coverage is imperfect and permits sophisticated traders to engage in insider trading with relative impunity so long as they do not give, receive, or promise any personal benefit. Currently, this "personal benefit" requirement is recognized and codified by proposed Section 16A(c)(1)(D), which unfortunately implies that the most sophisticated traders can find a way to lawfully engage in egregious insider trading. It would be very easy to delete the "per-

sonal benefit" requirement from the above Section, and then the statute would prescribe virtually all forms of trading that were based on material nonpublic information.

If insider trading can persist so long as no personal benefit is given or promised, this will imply that "agency costs" in corporate governance will remain high because managers can secretly profit without disclosure. At bottom, most forms of insider trading involve a theft or embezzlement of information. Stealing is never efficient and always injures investors, but it could be largely precluded if the "personal benefit" standard were deleted from Section 16A(c)(1)(D).

**Q.2.** Do other industries that trade in nonsecurities, such as energy, currencies, and agriculture commodities, experience insider trading perpetrated by bad actors? Would it be beneficial to ensure that insider trading statutes exist in these markets?

**A.2.** Good question! There is little empirical data on the extent of informed trading in other markets. The Commodity Futures Trading Commission (CFTC) now has a recently revised statute that now precludes insider trading, but I am not aware of how often it has been used. In general, trading in the commodities markets is not on a firm-specific basis, and thus specific shareholders of a company are not prejudiced. Conceivably, there can be insider trading in cryptocurrency and related derivative markets, but generally the greater danger in these markets is market manipulation, which would require a different statute and probably can be prosecuted to some extent under existing law. Nonetheless, your question is a good one to which a thorough and adequate answer cannot today be given.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

## LETTER SUBMITTED BY NASAA

NASAA

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.
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www.nasaa.org

April 5, 2022

The Honorable Sherrod Brown
Chairman
Senate Committee on Banking, Housing,
and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Patrick J. Toomey
Ranking Member
Senate Committee on Banking, Housing,
and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Re: Promoting Trust in Our Capital Markets

Dear Chairman Brown and Ranking Member Toomey:

On behalf of the North American Securities Administrators Association, Inc. ("NASAA"),[1] I am writing to commend the U.S. Senate Committee on Banking, Housing, and Urban Affairs for holding a hearing to examine illegal insider trading legislation. As explained below, while NASAA supports swift passage of legislation to combat illegal insider trading, we also urge Congress to pass a package of reforms that will foster greater trust in our capital markets.

At NASAA, we work independently and collaboratively with many external partners such as academics, consumer advocates, legislators, regulators, and trade associations to help ensure that entrepreneurs, investors, and others trust our capital markets and will continue to use them for generations to come. To encourage the trust of America's hard-working entrepreneurs and investors in our capital markets, we protect investors, promote responsible capital formation, and support inclusion and innovation. Yet, nearly 15 years after the 2008-2009 Financial Crisis, a concerning amount of distrust in our capital markets persists. Indeed, large numbers of U.S. adults across all age demographics remain skeptical of Wall Street's institutions, professionals, and products.[2]

As stated above, Congress should act on a swift, bipartisan basis to pass legislation, including insider trading legislation, that will help to foster trust and participation in the regulated markets. In doing so, Congress should prioritize proposals that strengthen accountability, compliance, investor education, registration, regulatory coordination, and transparency. The following is a representative list of proposals to approve:

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[1] Organized in 1919, NASAA is the oldest international organization devoted to investor protection. NASAA's membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico, and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grassroots investor protection and responsible capital formation.

[2] For various reasons, we know that many U.S. adults do not trust our capital markets. For example, in a survey conducted in March 2022, the percentages of Gen Z, Millennial, Gen X, and Baby Boomer respondents who expressed trust in Wall Street were 20%, 39%, 31%, and 40%, respectively. *See* Morning Consult, Tracking Trust in U.S. Institutions (Mar. 2022). *See also* Bankrate, Survey: More than half of investors think the stock market is rigged against individuals (Mar. 2021) and P. Sapienza and L. Zingales, Financial Trust Index (Feb. 5, 2020).

1. **The Empowering States to Protect Seniors from Bad Actors Act** (H.R. 5914 | S. 3529): This bicameral, bipartisan bill, which the House Financial Services Committee approved by a voice vote in November 2021, would establish a grant program that would enhance existing efforts by state securities and insurance regulators to protect senior investors and policyholders from financial fraud. Importantly, with respect to the grant program, the bill would: (A) make the U.S. Securities and Exchange Commission ("SEC") the program administrator; (B) give the SEC the authority and tools necessary to operate a data-driven grant program; (C) empower the SEC to make grants to state regulators from across the United States; (D) authorize an appropriation of $10,000,000 to the SEC for each of the fiscal years 2023 through 2028 to make such grants; (E) require the SEC to cap each grant at $500,000; and (F) effectively create more opportunities for federal and state securities regulators to communicate and coordinate in their efforts to protect senior investors.[3]

2. **The Insider Trading Prohibition Act** (H.R. 2655 | S. 3990): S. 3990 would make it easier for market participants, courts, and other stakeholders to identify, follow, and enforce the law by creating a codified definition of illegal insider trading. In short, the bill would make it unlawful for a person to trade while aware of material, non-public information if that person knows, or has reason to know, that the information was obtained wrongfully. In addition, the bill would prohibit a person with material, nonpublic information from wrongfully passing along that information to others, or tipping them, if the person is aware that the communication would result in trading and the recipient in fact trades based on that communication. In May 2021, the U.S. House of Representatives ("House") passed H.R. 2655 by a vote of 350 to 75.[4]

3. **The 8–K Trading Gap Act of 2021** (H.R. 4467 | S. 2360): This bicameral legislation, which received bipartisan support last Congress, would close a loophole by requiring the SEC to prohibit corporate insiders from making trades during the four-day period they have between the occurrence of a significant event – such as bankruptcy or an acquisition – and the public company's legally-mandated disclosure. The SEC requires public companies to file an 8-K to announce significant events relevant to shareholders. Companies have four business days to file an 8-K for most specified items.[5]

4. **The FAIR Act of 2022** (H.R. 963 | S. 505): Last month, the House approved this bicameral, bipartisan legislation by a vote of 222 to 209. The bill was referred to the Senate Committee on the Judiciary. Among other things, this legislation would prohibit broker-dealers and registered investment advisers from including pre-dispute arbitration clauses in customer

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[3] *See* NASAA, Letter to SBC Leadership Regarding S. 3529, the Empowering States to Protect Seniors from Bad Actors Act (Jan. 25, 2022); NASAA, Letter to HFSC Leadership Regarding H.R. 5914, the Empowering States to Protect Seniors from Bad Actors Act (Nov. 15, 2021).
[4] *See generally* NASAA, Letter to Rep. Himes Regarding H.R. 2655 (May 17, 2021); Written testimony of Melanie Senter Lubin, Putting Investors First: Reviewing Proposals to Hold Executives Accountable (Apr. 3, 2019).
[5] The House passed The 8-K Trading Gap Act of 2019 by a vote of 384 to 7. *See* Van Hollen, Maloney Introduce Bicameral Legislation to Help Eliminate Corporate Insiders' Unfair Advantage in Stock Sales (July 15, 2021).

contracts as well as invalidate any standing mandatory pre-dispute arbitration clauses in current employment and customer agreements.[6]

Notably, at this time, we are not recommending that Congress pass the Promoting Transparent Standards for Corporate Insiders Act (H.R. 1528 | S. 2211). In short, this bill would direct the SEC to study and report on possible revisions to regulations regarding Rule 10b5-1 trading plans and to revise regulations consistent with the results of the study. Though NASAA called on Congress to conduct oversight with respect to Rule 10b5-1 plans and expressed support for this bill in early 2021,[7] the SEC has since published a proposed rule relating to Rule 10b5-1 plans and insider trading. On April 1, 2022, NASAA submitted a comment letter stating that we generally support the proposal. Our comment letter suggested ways in which the SEC could improve the proposal to make it a more meaningful enhancement of the insider trading laws.[8]

Thank you for your consideration of NASAA's comments. Should you have any questions, please do not hesitate to contact Kristen Hutchens, NASAA's Director of Policy and Government Affairs, and Policy Counsel, at khutchens@nasaa.org.

Sincerely,

Melanie Senter Lubin

Melanie Senter Lubin
NASAA President
Maryland Securities Commissioner

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[6] *See generally* NASAA, Letter to SBC Leadership Regarding Mandatory Arbitration Agreements in Our Capital Markets (Mar. 12, 2022) (explaining that NASAA believes Congress should act now on a swift, bipartisan basis to empower investors and give them a choice when it comes to resolving disputes with securities firms and professionals).

[7] *See* NASAA, Legislative Agenda for the 117th Congress, at p. 14; NASAA, Letter to HFSC Leadership Regarding the Promoting Transparent Standards for Corporate Insiders Act (Mar. 8, 2021).

[8] NASAA, Comment Letter Regarding SEC Rule 10b5-1 and Insider Trading Proposal (Apr. 1, 2022).

## LETTER SUBMITTED BY COALITION SUPPORTING JOBS ACT 4.0

April 5, 2022

Dear Chairman Brown, Ranking Member Toomey, and Members of the Committee,

We the undersigned write in strong support of the JOBS Act 4.0 capital formation package and would like to thank Ranking Member Toomey and the Members of the Senate Banking Committee for their leadership on this important issue. Capital markets play a vital role in the U.S. economy, providing many small businesses, entrepreneurs, and startups with the access to capital they need to innovate, grow, and create jobs.

Financial regulations should be crafted with the understanding that market participants are best positioned to make their own financial choices, and regulators should focus on protecting against bad actors and fraud. Creative destruction, risk-taking, potential for failure, and consumer choice are all necessary parts of an advancing economy.

Many small businesses, startups, and entrepreneurs rely on the ability to raise the capital needed to start and grow their business. A vibrant business and startup ecosystem contributes to higher economic growth, job creation, wages, and investment. Consumers also benefit from the innovative services and technological advances they provide. As American businesses and families face higher prices and costs of living, regulations that hamstring economic activity should be especially concerning.

While U.S. capital markets are the largest in the world and account for over 70 percent of financing for non-financial firms in the U.S.[1], in many ways they are failing businesses and investors. This is in large part due to poorly drawn securities laws and financial regulations at the state and federal level. There has been a remarkable decline in companies going public,[2] and the costs imposed by the current regulatory regime have made it less attractive to do so. But private securities markets are also in need of serious reform. According to Securities and Exchange Commission (SEC) data, in 2018, $1.4 trillion was raised through public, registered offerings compared to $2.9 trillion in offerings made through the SEC's exemption framework.[3] While private markets provide important opportunities for businesses and investors, current regulations often limit those opportunities to affluent investors and certain exemptions have fallen short of their intended goals.

Instead of reining in regulations that have stunted investment and capital formation, the SEC has doubled down on imposing burdensome and costly regulations on American businesses and investors. The [capital markets agenda] addresses many of those regulatory burdens head on, making it easier for businesses and investors to participate in U.S. capital markets.

Among the many commendable pieces of legislation introduced, we would like to highlight that this capital formation agenda would help businesses access capital by:

- Creating a micro-offering exemption to help small businesses and entrepreneurs gain access to capital without having to face burdensome and costly mandated disclosures or offering filings. **(S. 3939 Small Entrepreneurs' Empowerment and Development (SEED) Act, Senator Tim Scott)**
- Making capital formation through crowdfunding more viable, benefiting issuers, investors, and funding portals. **(S. 3967 Improving Crowdfunding Opportunities Act, Senator Moran)**

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[1] https://www.sifma.org/resources/news/10-facts-about-the-us-capital-markets-2021/

[2] https://corpgov.law.harvard.edu/2017/05/18/looking-behind-the-declining-number-of-public-companies/

[3] https://www.sec.gov/rules/concept/2019/33-10649.pdf

- Expanding capital formation by exempting certain secondary offerings of Regulation A securities from state regulation. **(S. 3966 Facilitating Main Street Offerings Act, Senator Moran)**
- Bringing an end to the uncertain and overbearing regulations faced by finders, allowing them to work better with small businesses and entrepreneurs to raise much needed capital. **(S. 3922 Unlocking Capital for Small Businesses Act, Senator Cramer)**
- Repealing unnecessary and burdensome disclosure requirements enacted under Dodd-Frank. These politically-charged disclosures place substantial costs on companies, and fail to protect investors or maintain fair, orderly, and efficient markets. **(S. 3923 Dodd-Frank Material Disclosure Improvement Act, Senator Cramer)**

We applaud Ranking Member Toomey the Members of the Senate Banking Committee for putting forward these critical pieces of legislation and urge Congress to swiftly pass these important reforms.

Sincerely,

Brent Wm. Gardner
Chief Government Affairs Officer
Americans for Prosperity

Daniel Garza
President
The Libre Initiative

Bryan Bashur
Executive Director
Shareholder Advocacy Forum

Karen Kerrigan
President & CEO
Small Business and Entrepreneurship Council

David McIntosh
President
Club for Growth

John Berlau
Director of Finance Policy
Competitive Enterprise Institute

Adam Brandon
President
FreedomWorks

Grover Norquist
President
Americans for Tax Reform

Garrett Bess
Vice President
Heritage Action for America

**LETTER SUBMITTED BY SBIA**

SBIA
SMALL BUSINESS
INVESTOR ALLIANCE

April 4, 2022

| | |
|---|---|
| Sen. Sherrod Brown, Chair | Sen. Pat Toomey, Ranking Member |
| Senate Banking, Housing and Urban Affairs Committee | Senate Banking, Housing and Urban Affairs Committee |
| U.S. Senate | U.S. Senate |
| Washington, D.C. 20510 | Washington, D.C. 20510 |

Dear Chair Brown and Ranking Member Toomey:

On behalf of its membership, the Small Business Investor Alliance ("SBIA) endorses the Senate Banking, Housing and Urban Affairs' JOBS Act 4.0, a comprehensive package of legislative reforms that would help improve capital access and investor protections. The SBIA is the national association that represents private funds investing in small businesses, business development companies (BDCs), small business investment companies, (SBICs), rural business investment companies (RBICs), and their investors. SBIA and its members promote a healthy climate for small business investment and job creation.

The proposed agenda includes many practical proposals that offer common-sense investor protections and streamlined regulations. SBIA recognizes the value of effective regulation that that promotes a healthy environment for domestic investment and is sensitive to the burdens placed on small businesses. In particular, the package includes provisions that would:

- Expand access to wealth creating investments by permitting individuals to qualify as an "accredited investor" by passing a SEC-developed skills exam;
- Expand the scope of the SEC's Office of Advocate for Small Business Capital Formation to explore and report about capital access issues facing rural-area small businesses; and,
- Direct the SEC to correct their rules to ensure that accurate information is reported to BDC investors.[1]

SBIA believes that this legislative package, if enacted into law, offers practical tools that would help expand access to capital for many small businesses, enable additional protections for investors, and encourage economic growth through our domestic capital markets.

SBIA applauds this collection of market reforms and urges Congress to move quickly to pass them.

Sincerely,

Brett Palmer

Brett Palmer
President

[1] Specifically, this bipartisan proposal, which also has a bipartisan House companion with 16cosponsors currently including senior members of the House Financial Services Committee, would change the SEC's 2006 acquired fund fees and expenses ("AFFE") rule for institutional and index funds that invest in BDCs.

529 14th St., N.W. Washington, DC 20045 (202) 628-5055 sbia.org

**STATEMENT SUBMITTED BY COALITION OF INNOVATION AND ENTREPRENEURSHIP ORGANIZATIONS**

# Coalition of Innovation and Entrepreneurship Organizations Applauds Announcement of Capital Formation Legislative Package

For Immediate Release

April 5, 2022

**Washington D.C.** – A coalition of advocates for the nation's startup ecosystem today applauded the announcement by Senator Pat Toomey (R-PA) of a legislative package containing a number of bipartisan provisions designed to further facilitate capital formation. The coalition includes: AdvaMed Accel, Angel Capital Association, Biotechnology Innovation Organization, Carta, Center for American Entrepreneurship, Coalition for Business Development, Engine, Financial Technology Association, Managed Funds Association, National Venture Capital Association, Small Business Investor Alliance, and TechNet.

"On behalf of the nation's startups, small businesses, their founders, employees, and investors—and on this tenth anniversary of the JOBS Act of 2012—we applaud the announcement of the JOBS Act 4.0 to further facilitate capital formation to fuel American innovation, economic growth, job creation, and opportunity," the coalition's members said. "The U.S. economy is the largest, most innovative, and dynamic in the world because of the American entrepreneurial spirit and its power to drive economic growth, solve problems, and expand opportunity. Given the far-reaching and tragic impact of the Covid-19 pandemic, access to capital is more important than ever to strengthen and solidify the post-Covid economic recovery.

"A decade ago, Congress passed the bipartisan Jumpstart our Business Startups (JOBS) Act to bolster the public and private capital market ecosystems. Recognizing the one size does not fit all, this transformational piece of legislation has been critical in providing capital-raising opportunities for companies at all stages in their life cycle, but particularly for small and emerging businesses—the lifeblood of the economy. We greatly appreciate renewed efforts by Congress to build upon the successes of the JOBS Act to further improve capital formation and investment opportunities, particularly for women, minority, and rural entrepreneurs and investors.

"We thank Senator Toomey and his colleagues for their leadership and look forward to working with Congress to ensure that America's entrepreneurs and innovators are able to effectively and efficiently raise the capital they need to deliver the growth, jobs, and opportunity the American people deserve."

## STATEMENT SUBMITTED BY SIFMA



sifma

# SIFMA Statement on JOBS Act 4.0 Discussion Draft

Type: Press Releases

Date: April 4, 2022

Contact: Lindsay Gilbride
lgilbride@sifma.org

**Washington, D.C., April 4, 2022 –** SIFMA released the following statement today from president and CEO Kenneth E. Bentsen, Jr., on a discussion draft of legislation (JOBS Act 4.0) aimed at accelerating new business formation, ahead of the 10th Anniversary of the JOBS Act:

"SIFMA strongly supported the passage of the Jumpstart Our Business Startups Act (JOBS Act) of 2012. The JOBS Act has helped promote job creation and economic growth by making it easier for companies to access capital while at the same time promoting transparency for investors. As such, SIFMA welcomes Ranking Member Toomey and the Senate Banking Committee's focus on new legislative avenues to boost economic growth, encourage job creation, and support entrepreneurs by improving our securities laws and regulations. U.S. capital markets are a critical source of financing for businesses – especially small and mid-sized businesses. Now is the time to tailor securities regulations to facilitate better access to the U.S. capital markets. SIFMA welcomes the opportunity to work with the Committee as it reviews the current regulatory structure and considers reforms to the various laws governing our capital markets to improve market efficiency and further facilitate capital formation."

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SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's one million employees, we advocate on legislation, regulation and business policy affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development.

SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA).

## S. 3990



117TH CONGRESS
2D SESSION

# S. _____

To amend the Securities Exchange Act of 1934 to prohibit certain securities trading and related communications by those who possess material, nonpublic information, and for other purposes.

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IN THE SENATE OF THE UNITED STATES

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Mr. REED (for himself and Mr. MENENDEZ) introduced the following bill; which was read twice and referred to the Committee on ____________

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# A BILL

To amend the Securities Exchange Act of 1934 to prohibit certain securities trading and related communications by those who possess material, nonpublic information, and for other purposes.

*Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,*

**SECTION 1. SHORT TITLE.**

This Act may be cited as the "Insider Trading Prohibition Act".

**SEC. 2. PROHIBITION ON INSIDER TRADING.**

(a) IN GENERAL.—The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by inserting after section 16 (15 U.S.C. 78p) the following:

**"SEC. 16A. PROHIBITION ON INSIDER TRADING.**

"(a) PROHIBITION AGAINST TRADING SECURITIES WHILE AWARE OF MATERIAL, NONPUBLIC INFORMATION.—It shall be unlawful for any person, directly or indirectly, to purchase, sell, or enter into, or cause the purchase or sale of, or entry into, any security, security-based swap, or security-based swap agreement if that person, at the time the person takes such an action—

"(1) has access to information relating to such security, security-based swap, or security-based swap agreement that is material and nonpublic and is aware (including if the person consciously avoids being aware), or recklessly disregards, that such information is material and nonpublic; and

"(2) is aware (including if the person consciously avoids being aware), or recklessly disregards, that—

"(A) the information described in paragraph (1) has been obtained wrongfully; or

"(B) the purchase, sale, or entry would constitute wrongful trading on the information described in paragraph (1).

"(b) PROHIBITION AGAINST THE WRONGFUL COMMUNICATION OF CERTAIN MATERIAL, NONPUBLIC INFORMATION.—It shall be unlawful for any person, the purchase or sale of a security or security-based swap (or entry into a security-based swap agreement) by which would violate subsection (a), to wrongfully communicate material, nonpublic information relating to that security, security-based swap, or security-based swap agreement to any other person, if—

"(1) the person communicating the information, at the time the person communicates the information, is aware (including if the person consciously avoids being aware), or recklessly disregards, that such communication would result in such a purchase, sale, or entry; and

"(2) any recipient of the wrongfully communicated information purchases, sells, or causes the purchase or sale of any security or security-based swap, or enters into (or causes the entry into) any security-based swap agreement, based on that communication.

"(c) STANDARD AND KNOWLEDGE REQUIREMENT.—

"(1) STANDARD.—For purposes of this section, trading while aware of material, nonpublic information under subsection (a), or communicating mate-

rial, nonpublic information under subsection (b), is wrongful only if the information has been obtained by, or the communication or trading on the information would constitute, directly or indirectly—

"(A) theft, conversion, bribery, misrepresentation, espionage (through electronic or other means), or other unauthorized access of the information;

"(B) a violation of any Federal law protecting—

"(i) computer data; or

"(ii) the intellectual property or privacy of computer users;

"(C) misappropriation from a source of the information; or

"(D) a breach of any fiduciary duty to shareholders of an issuer for a direct or indirect personal benefit, including—

"(i) an existing or future pecuniary gain or reputational benefit; or

"(ii) a gift of confidential information to a relative or friend.

"(2) KNOWLEDGE REQUIREMENT.—It shall not be necessary that a person trading while aware of information in violation of subsection (a), or making

a communication in violation of subsection (b), knows the specific means by which the information was obtained or communicated or traded on, or the specific benefit described in paragraph (1)(D) that was received, paid, or promised by or to any person in the chain of communication, if the person trading while aware of the information or making the communication, as applicable, at the time the person makes the trade or communicates the information, is aware (including if the person consciously avoids being aware), or recklessly disregards, that the information was wrongfully obtained, wrongfully traded on, or wrongfully communicated.

"(d) AFFIRMATIVE DEFENSES.—

"(1) IN GENERAL.—The Commission may, by rule or by order, exempt any person, security, or transaction, or any class of persons, securities, or transactions, from any or all of the provisions of this section, upon such terms and conditions as the Commission considers necessary or appropriate in furtherance of the purposes of this title.

"(2) RULE 10B5–1 COMPLIANT TRANSACTIONS.—The prohibitions of this section shall not apply to any transaction that satisfies the require-

ments of section 240.10b5–1 of title 17, Code of Federal Regulations, or any successor regulation.

"(e) RULE OF CONSTRUCTION.—The rights and remedies provided by this section shall be in addition to any and all other rights and remedies that may exist at law or in equity (without regard to whether such a right or remedy is provided under this Act) with respect to an action by a person to—

"(1) purchase, sell, or enter into a security, security-based swap, or security-based swap agreement while aware of material, nonpublic information; or

"(2) communicate material, nonpublic information relating to a security, security-based swap, or security-based swap agreement.".

(b) CONFORMING AMENDMENTS.—The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended—

(1) in section 3(a)(78)(A) (15 U.S.C. 78c(a)(78)(A)), by inserting "16A," after "16,";

(2) in section 21(d)(2) (15 U.S.C. 78u(d)(2)), by striking "or the rules or regulations thereunder" and inserting ", section 16A of this title, or the rules or regulations under either such section";

(3) in section 21A (15 U.S.C. 78u–1)—

(A) in subsection (g)(1), by striking "section 10(b) and Rule 10b–5 thereunder" and inserting "section 10(b), Rule 10b–5 thereunder, and section 16A"; and

(B) in subsection (h)(1), by striking "section 10(b), and Rule 10b–5 thereunder" and inserting "section 10(b), Rule 10b–5 thereunder, and section 16A"; and

(4) in section 21C(f) (15 U.S.C. 78u–3(f)), by striking "or the rules or regulations thereunder" and inserting ", section 16A, or the rules or regulations under either such section".